CONSUELO MACK | WEALTHTRACK

Program #1405
Broadcast: July 21, 2017

Finding rare sources of income in a low income world with Brandywine Global's Stephen Smith and Western Asset Management's John Bellows.

John Bellows
Research Analyst/Portfolio Manager
Western Asset Management

Stephen Smith
Co-Lead Portfolio Manager
Legg Mason Brandywine Global Opportunities Fund

CONSUELO MACK: This week on WEALTHTRACK, two award winning bond managers discuss why inflation and interest rates can remain low for a very long time. What it means for investors is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack.
Two of the most unusual features of this now nine year-old economic recovery are intertwined: Historically low interest rates and persistently subdued inflation. First, the unprecedented scope of monetary easing and money creation that has taken place since the financial crisis has kept downward pressure on interest rates.

Leading economic research firm, Evercore ISI detailed it in a report recently headlined:
Money, Money, Money, Money! Describing the explosion in money supply that has occurred over the last decade.
- Japan's major money supply measure, M2 is up 35% to $9 trillion dollars…
- China's soared an astonishing 350% to $23 trillion dollars…
- U.S. M2 accelerated 100% to $14 trillion…
- And the eurozone's money supply advanced 50% to $13 trillion.

Cumulatively that adds up to $59 trillion, more than the annual gross domestic product of all four regions. Combined.

But what is considered to be almost as unusual is the fact that this flood of money did not spark an explosion in inflation. The dire warnings never materialized. In fact inflation has remained remarkably subdued. It has been under the Federal Reserve's target of 2% for much of the recovery.

Another surprise to many is that economic growth has been much weaker in this expansion than in prior cycles. Nominal GDP, that's with inflation included, has actually been running at levels normally found in recessions, despite all of the unprecedented central bank policies to boost activity.

Investing during these unusual times has been challenging but this week's bond manager guests have been successfully navigating these tricky waters.

John Bellows is a Portfolio Manager and Research Analyst at Western Asset Management. Among his many responsibilities is being a member of Western Asset's Core Plus Strategy Team and managing the Core Plus separate accounts.

The core is investment grade corporate bonds, the plus comes from smaller positions in other riskier assets such as high yield and non-U.S. and emerging market debt. The mutual fund equivalent is Western Asset's Core Plus fund which is rated five star by *Morningstar*.

Stephen Smith is Co-Lead Portfolio Manager of Global Fixed Income at Brandywine Global Investment Management which he joined in 1991 to build its bond business.

He is also Co-Lead Portfolio Manager of the Legg Mason Brandywine Global Opportunities fund which he launched in 2006. A *Morningstar* fixed income fund manager of the year finalist in 2014 it has a 4 star rating and has a history of beating its bond market benchmark and its world bond category peers since inception. Smith and his team invest in global bonds and currencies with a focus on government bonds, known as sovereign debt.

I started the conversation by asking each for their inflation outlook.

JOHN BELLOWS: It's a really important question for bond investors and for markets more generally. I'll start with a little bit of background. Inflation moved up in the United States at the end of last year. It was moving up at the beginning of this year as well.

CONSUELO MACK: Moving up to ...

JOHN BELLOWS: Not a lot, but we did see inflation, CPI inflation moving up past two percent. It had been below two percent, and it moved past two percent. At the time at the beginning of the year, we were concerned that inflation was not going to keep moving up, and we thought it would stabilize and maybe even move a little bit lower.
The reason for that view is that our view is the long-term secular forces continue to be deflationary in nature, an aging population, quite a bit of over capacity in supply chains around the world, not a lot of bargaining power from U.S. workers. All those are working to keep inflation low, and so we were looking for that momentum at the beginning of this year to peter out and for a stable inflation outlook. What's actually happened is inflation has moved lower. So perhaps ...

CONSUELO MACK: Why? What's going on? What are the dynamics that are pushing inflation lower?

JOHN BELLOWS: I think there's kind of two issues. I think one's a technical issue. You have seen some repricing of things like cell phone services. That will move the indices in potentially big ways, although it may not have a huge impact on our spending on a day-to-day basis. But I think the bigger issue is that we're just not seeing a lot of inflationary impulses anywhere. As I said, wages aren't moving up very fast. There's not a lot of inflation in Europe and Japan, really around the world, and without that inflationary impulse, it's really hard for U.S. inflation to move up. So as I said, at the beginning of the year we thought inflation momentum would stall and move sideways. What's actually happened is inflation has moved lower, and I think from here we continue to be concerned about the inflation outlook and continue to be concerned about the downside risks. I think our base case outlook is that inflation can stabilize a little bit. But again, with those longer-term secular deflationary forces, we remain concerned and watchful of those downside risks to inflation.

CONSUELO MACK: Same outlook at Brandywine Global, Steve, or anything different?

STEPHEN SMITH: Yes.. the core CPI which is what the Fed looks at, it's been under two percent since 2012.

CONSUELO MACK: Below their target.

STEPHEN SMITH: So, they've never been able to get it above there except I think for one quarter. So, I just look at it as we've had this surge of inflation because of oil, but it was more in the CPI, and that inflation's under control and not just in the U.S. but basically globally. Inflation just came down 50 basis points around the world, and it's because, as we just discussed, there's just not much pricing power. I still don't see much pricing power. So, I think inflation is just going to stay globally stuck in that maybe one and a half percent range.

CONSUELO MACK: So, what does that tell us about central bank policy as far as the Fed is concerned? Basically, as long as it doesn't keep going too much below two percent, do they have to do much? Especially since it looks like kind of as full employment as you can get. That's their dual mandate, so do we need much more action from the Fed?

JOHN BELLOWS: The short answer I think is no. The Fed doesn't need to be tightening policy very much in the current environment when inflation is low. Just the broader perspective here is the Fed and really all policymakers have a growth mandate in mind. They want to support labor markets. They want to support incomes, but they do that subject to the inflation constraint. You can't support growth if that's just going to generate a lot of inflation. So, they really watch inflation carefully because that tells them how much support they can give to the broader economy. In the current environment where inflation's not accelerating, that means that the Fed can stay supportive of the recovery. They can allow the unemployment rate to remain low. They can allow job growth to continue. They can allow GDP growth to continue without being too concerned about tightening for inflation reasons.

CONSUELO MACK: What about other central banks, Steve?

STEPHEN SMITH: This is a more complicated question. So, we've been thinking about the world, that the world's going to maybe normalize, and so normalization ...

CONSUELO MACK: What does that mean?

STEPHEN SMITH: Well, I was actually thinking last year when we were doing our quarterly letters, now we've been very bearish on the U.S. dollar, and so after Trump got elected the dollar went through the roof and commodity prices went through the roof, and we stayed the course. We added more foreign securities. We actually added some long bonds in our portfolio. So back in October when we wrote our quarterly letter, the biggest adjective we could come up with to describe the environment was something stirring, because if we would have said we're going to have growth, it was like most people weren't into that camp. Then at the end of the year we came to the conclusion after Trump got elected and confidence went up

that maybe we're going to have a synchronized global growth.
Now we are into the idea that maybe the world can normalize, so, I was thinking what we're having now is that the U.S. is going to lead it. We've been raising interest rates. I always say you can observe a lot by observing. We're raising rates. The housing market's okay. The stock market's okay. They're going to probably continue to raise rates very gradually. They're going to reduce the size of the balance sheet, and Draghi basically said it.
By the end of the year or early next year they're going to be in the same position as the U.S. and they'd be followed by Japan. So, we're actually thinking that ...

CONSUELO MACK: Gradually withdrawing the accommodation, lowering their balance sheets.

STEPHEN SMITH: Withdrawing all the accommodation. So, that would be a normalization.

CONSUELO MACK: I see.

STEPHEN SMITH: Maybe we'll get a more normal business cycle after spending eight years with the central banks practicing all these new negative real rates, negative rates and buying all these bonds around the world.

CONSUELO MACK: There were two great fears with this policy of just these extraordinary monetary policies that we've seen since the financial crisis, and one was that it would be extremely inflationary because the Fed's balance sheets, the money supplies were growing at triple digit numbers in some countries including our own. That it would be inflationary and also that if the stimulus was withdrawn that it would cause kind of another crisis.
You saw the taper tantrum, but so far, we're seeing these very gradual moves by the Fed for instance, and we're really not seeing any tremendously negative response from the markets. So, can they pull this off? I guess that's my question to you, John, without setting off a crisis.

JOHN BELLOWS: I think that's a really important perspective to note that the things that markets and the Fed itself was worried about when they started this experiment have not materialized. Inflation is kind of the dog that didn't bark, and on the financial stability risks what we've actually seen is that credit growth has been more or less in line with GDP growth, not suggesting a buildup of excesses, not suggesting a lot of vulnerabilities, and for that reason we remain pretty sanguine about where the U.S. is. Again, inflation is a little bit lower than it probably should be but there are no financial excesses, and we think growth can continue.
In terms of can the Fed pull this off, I guess what I'd point to is really that context matters a lot, and Steve said earlier we have seen a little bit better tone in global growth. Europe's doing a little bit better. China has been a little bit better over the last few quarters. The U.S. is perhaps a little bit better and that context is really important. So, if the Fed and the ECB are normalizing in the context of better global growth then that's kind of a second-order issue for financial markets. The first-order issue is the better global growth.
Now if the Fed and the ECB and others were normalizing in an environment of worse global

growth, that would be a much different scenario, and that would be much more concerning, but I think in the current scenario the context is really important. The context is positive, and it kind of means that the central banks are somewhat in the background rather than the foreground.

CONSUELO MACK: So could we for the foreseeable future, Steve, could we actually see just this low inflation, low growth environment and just continue regardless of what the traditional length of a recovery is? So, we might be in the third longest recovery, and then it's going to be the second, and then it's the longest, but as long as we keep chugging along, then in fact this could go on for quite a while, this environment. Is that possible?

STEPHEN SMITH: It is possible.

CONSUELO MACK: Is it likely?

STEPHEN SMITH: Because what's happened if you look at it from a global perspective, not a U.S. perspective, Draghi had his expression of will we put a stake in the ground back more than five years ago. Then the Chinese got it wrong in 2015. Monetary policy or lending was really way too tight, and so we've had three reflation trades; all three of them petered out. This one I do believe is actually going to play itself out, and you're going to normalize. We haven't been able to do that.

CONSUELO MACK: You're talking about globally, not just the U.S.

STEPHEN SMITH: But the U.S. is leading it, the thing that's been missing globally is confidence, and for whatever reason after Donald Trump got elected, not to argue about the ...

CONSUELO MACK: The confidence picked up.

STEPHEN SMITH: Confidence picked up here. It picked up in China. It picked up globally.

CONSUELO MACK: John.

JOHN BELLOWS: If I could just come back to a point you made about the recovery. I think there's a misperception out there that the length of the recovery matters. People talk about the third longest recovery.

CONSUELO MACK: They do.

JOHN BELLOWS: The second longest recovery is 90 months. It's seven years, whatever it is. There's nothing in economics that's based on time. Everything in economics is based on magnitudes, and yes this recovery is long in months, but the growth rates have been so low that the magnitude of the recovery is actually still very, very shallow. What that means is we haven't built up any excesses. If you're growing at a very low rate, there is no opportunity for businesses or consumers to lever up very much, to take on a lot of things that may cause problems down the road. So yes, it's long in months, but it's very short. It's very small in magnitude, and in economics the magnitude is much more important. So, it's something that's out there. You hear that a lot, but we would challenge whether or not the number of months actually matters, and instead we would look at the magnitude which is still shallow and suggests there's a lot of room left to go in this recovery.

STEPHEN SMITH: I would say I would agree with that because Australia is ...

CONSUELO MACK: You would agree with that.

STEPHEN SMITH: Australia is a quarter of a century into a recovery without a recession, and I just did something for a speech where if you take the top of the cycle in 2007 to today, the U.S. GDP has grown a robust 13 percent from the top. That's 1.3 percent since 2007. You take the 1960 recovery which was the best. GDP was up 52 percent over almost the same time horizon.

CONSUELO MACK: What a huge ...

STEPHEN SMITH: Four and a half percent growth. You can imagine what that does to tax revenues. So this has been, with all the regulation, that's what we've been thinking about. The regulation, Dodd-Frank, all these things had a profound impact on the economy, and I would agree that time-wise it's long, but I think that it can go on for another couple of years or more.

CONSUELO MACK: From an investment point of view, if it's going to be low inflation, that means low interest rates still. Where do we go for income, and where are the opportunities that you're seeing, John, at Western Asset?

JOHN BELLOWS: Well, quickly just on the low inflation and one implication of that. One implication as you note is that does keep bond yields in a low range. It also means that investors are well served by having some bonds in their portfolio. The reason you have bonds in your portfolio ...

CONSUELO MACK: Explain that.

JOHN BELLOWS: .... is that not only do bond yields stay low and so you earn the income on them, but if you have a low inflationary environment, that means that bonds are a very good diversifier for other risk assets. The primary risk in such an environment is that growth were to falter, that would be tough for risk assets whether that's equities or some other types of risk assets we come back to, and in an environment where growth were to falter because inflation is low, that means bond yields are going to fall. Bond prices are going to rise, and that means they provide a good diversification.

Now you asked a question which we get a lot and it's a very important one which is, where do you go for income? In the current environment with bond yields low because of the inflation outlook, ten-year Treasuries are not a place you would normally look for income.

CONSUELO MACK: Except they've done well on a total return basis.

JOHN BELLOWS: They have, but that says yields have fallen. So if yields move sideways, you're getting a little bit of income, but you're not getting a lot. One area that we think is promising is some emerging markets. Those are places where yields are higher. Central banks and a number of these markets have raised rates to deal with inflation problems, to deal with weak currency problems, and they're coming out the other side of that relatively well-positioned. So a place like Brazil, a place like Russia raised rates over the last few years in order to bring down inflation and stabilize their currency, and here we are a few years later. Inflation is coming down. Their currencies have stabilized, and yet you still get that high real rate. You still get that additional income from investing in those currencies.

CONSUELO MACK: You know that our audience out there is saying, "Oh, great. Russia and Brazil. Not." I mean it strikes us as being very high risk, and that's very much at the margins. That's obviously in your Core Plus portfolio. That is at the margins.

JOHN BELLOWS: So I think that's exactly right. So, I'd make two points there. One is it's very important to have that in a diversified portfolio, and so the discussion about what's your safe asset against that is very important when you're thinking about it. It's important to do correct sizing, et cetera, but the other thing that's important to think about is the headlines have been negative, and in some sense, that creates the opportunity. Those particular markets I'd include Mexico here. I'd include Indonesia, perhaps India. Those are places where the headlines have been relentlessly negative. That's in part why those assets have underperformed, and that in a sense is a value opportunity. So, you don't ever buy something just because the news is bad or the prices are low, but in these cases we think the fundamentals are somewhat stronger than those negative headlines would suggest, and that's what creates ...

CONSUELO MACK: And they'll make their interest payments.

JOHN BELLOWS: Yes.

CONSUELO MACK: This of course is your area of expertise which is sovereign debt. So, what's your strategy at Brandywine Global? You're doing sovereign debt which are government bonds for our audience, and you're doing currencies as well.

STEPHEN SMITH: Well, one of the reasons I was thinking about this whole idea of normalization was that if you just look at the world from trying to take time and perspective, you look at the belly of the year 2015, the world growth in real terms was 1.6 percent which historically was a recession. Your nominal growth was close to three percent which is again at recessionary level. Commodity prices bottomed in November of 2015. This is why the dollar and the commodity prices have been doing a little bit better. Our theory was if the dollar went up in value, we import deflation. The emerging markets import inflation not from anything that they're doing on their own. It's the central bank here. They're raising interest rates, and so they had this big negative feedback loop in 2014 and 2015, and now with the dollar weakening, they got commodity prices up. They can now lower interest rates. They've been doing that now just in aggregate the last year or so, and so you get a positive feedback cycle, and so I think that's where we are, and if you look at from today versus the five or six months in '15 when world growth was 1.6, world growth is now close to three percent. It's a lot better, and if you look at the first quarter of this year, what we're interested in and the way we're invested and how you can make money and why I think internationally, corporate profits in the U.S. were up 5.1 percent in the first quarter. Corporate profits in China were up 30.6 percent. Corporate profits in Europe were up almost 20 percent. So, if you go around the world, corporate profits in South America were up like 25 percent. So it's all about relative, to me, growth rates. The U.S. is going into the ninth year of an economic advance. The rate of change and the rate of change tends to be a lot slower, and I think the rest of the world is going to do better. FDI flows are going to go there, and I actually agree that interest rates in the emerging markets are all real. You can get real rates of three to five percent in a developed world but real rates other than probably the U.S. are all negative.

CONSUELO MACK: Would you agree with opportunities that ...

STEPHEN SMITH: I'm not going to repeat. It's the same as ...

CONSUELO MACK: ... John was talking about, Brazil, Russia, Mexico.

STEPHEN SMITH: We don't own Russia, but we have five percent positions like in Indonesia, in India, 15 percent in Mexico, five percent in Brazil, a lot of the EMs, and we think that's a great strategy because that's where the growth is.

CONSUELO MACK: Again, that's government debt that you're talking about. Are you as well talking about ... you're not talking about corporate credits. You're talking about both.

JOHN BELLOWS: I think there's opportunities in corporate credit as well. It's a different story, so the high real rates that's primarily a government debt story. In the corporate debt, those tend to be dollar-denominated and tend to be somewhat lower yields, but in some cases, there are opportunities there as well.

CONSUELO MACK: But the core of your portfolio, what would enable me as an investor to feel comfortable, to sleep at night? What would the core be in the Core Plus portfolio for instance?

JOHN BELLOWS: We would go back to – and I don't mean to sound like a broken record – but we go back to diversification. So, we do have some assets like emerging markets that do have some higher volatility, but we think it's really important to have an offset government debt, U.S. government debt that provides that diversification. Something that's somewhat in the middle that we also have in the portfolio would be investment grade corporate credit here in the United States.

CONSUELO MACK: Triple B or above.

JOHN BELLOWS: Triple B or above. We think the better tone in U.S. growth, perhaps a little bit of relaxing of the regulations that Steve was discussing should be a positive there. It's a little bit harder case to make that there is value, spreads. So the yield advantage over Treasuries has come way down. It's not the same opportunity it was last year, but that said, the story remains relatively positive. Again the key is the diversification, and the key is having some risk assets but against that having safe assets, and the way those two work together in portfolios, that's what really increases the return and reduced volatility over time.

CONSUELO MACK: Where are the best opportunities as far as currency investments are concerned?

STEPHEN SMITH: Well, I think that if you do believe we're in not the early phases but at least the mid cycle of an economic recovery, so the bottom in '15, now finally people are thinking, oh my gosh, we are actually having a recovery. So, I do believe like the EM. We own long bonds there. By that I mean anywhere from ten to 30-year securities, whichever is the long end. Like in Brazil you can't go longer than ten years. They don't issue bonds longer than that. In Mexico, you can own 30-year bonds. So we have sort of bimodal.
There's a lot of emerging market debt in emerging markets and long bonds. In Europe, our positions are like in Sweden, Poland, Czechoslovakia. It's the peripheral and in the U.K. and the reason, just looking at Europe, I mean I just think Poland is a poster child for this. They're growing at like seven percent. Employment is growing at four and a half percent year over year which would be the equivalent of us adding 600,000 jobs a month, and so you could say the same thing. In various ways, they rhyme in a lot of the other Eastern European countries, and so when you take it in aggregate, we only have not even 15 percent of our money in the U.S. That's mostly in long Treasuries and a few corporates because we've been paring down our corporates because spreads are ... I don't know. They just don't get much narrower. So, we actually have I would say like a bimodal portfolio. We either own long bonds or we own cash, and so a lot of the countries where we're invested like in Europe, it's just in short-term debt because we don't think that there's much value in the bond markets over there.

CONSUELO MACK: If there's one investment that we should all own some of in a long-term diversified portfolio, what would you recommend?

JOHN BELLOWS: We'd be in the emerging markets space, so Mexico. Currently Mexico yields are around seven percent on ten-year Mexico debt. That would be a position we'd have.

CONSUELO MACK: Steve, same question.

STEPHEN SMITH: Our biggest position is Mexico, and 30-year bonds yield seven and a quarter percent, and we have a big position in Brazil, yielding ten and a half percent. We think both of those places are fine.

CONSUELO MACK: So we're going to leave it there but, John Bellows, it's so great to have you from Western Asset Management.

JOHN BELLOWS: Thank you.

CONSUELO MACK: Thanks for joining us. Steve Smith, it's great to have you back on WEALTHTRACK from Brandywine Global.

STEPHEN SMITH: Well, thank you. I really enjoyed it.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term.
This week's action point picks up on a recommendation John Bellows made which is to:
Own some bonds to diversify your portfolio. Historically investment grade corporate bonds and treasury bonds have been non-correlated assets, in other words when stocks go one way they go the other and provide a counterweight to stock prices.
Even with rates still near historic lows and central banks around the world talking about raising rates, some bond ballast is still a good idea.

Next week we are turning our attention to companies with high growth rates. Baron Opportunity Fund's Michael Lippert joins us with his thoughts about Amazon and Tesla among others.
To see this program again and hear Bellows' and Smith's concerns about bond index funds click on the EXTRA feature of our website WEALTHTRACK.com.
Also feel free to reach out to us on Facebook and Twitter.

Thank you for watching. Have a great weekend and make the week ahead a profitable and a productive one.