Video Transcript: Inflation, Recession Risk, and Duration
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Katie Klingensmith [00:00:05] Welcome, everybody, to today's discussion, which is part of the series of Brandywine Global deep dives Around the Curve. I'm Katie Klingensmith with Brandywine Global, and I'm delighted to be accompanied by Francis Scotland, who is our head of research here at Brandywine Global. We've heard a lot going into this year around the direction of U.S. growth, but particularly U.S. inflation. And I'm excited to have a conversation today with Francis around the direction of growth, inflation, and the U.S. Treasury curve. With that, Francis, just get us started. What is your view of inflation right now in the U.S.?

Francis Scotland [00:00:42] Hi, Katie. It's nice to be here again. Well, the short answer for me is the direction is down. I don't think there's a lot of dispute about that anymore. The real question is, are we going to 2% or are we going to hit 3 to 4% and then level out. And my view is we're going to go to 2%, maybe even even lower. There's a chance we go even lower. So as you know from a lot of the conversations we've had in the past about the outlook and this particular topic, our view has been shaped by the idea that this isn't a normal business cycle. We're living through the normalization of the economy following a disaster brought on by the pandemic, and the lockdowns, and the various reactions to that. So just to recap really briefly, we had the biggest bust in history. The authorities reacted to it with historic reflationary stimulus on a scale that we'd never seen before. And so as a result, we experienced the sequence of inflation rolling through asset markets. We had asset market inflation. Then we got commodity market inflation. We got real estate inflation, and ultimately, we got inflation in goods and services itself. So in late 2021, the Federal Reserve started to get nervous that inflation might not be transitory after all. And they really started to get nervous when they saw this reflationary impulse roll into wage inflation. And then they pivoted. They shifted the narrative from "it's transitory" to "it's structural." And the shift really felt like they were panicking over the realization that they got it really wrong, and they needed to catch up in order to preserve the inflation credibility. So what's happened since they made their pivot? It's been a bit like watching a movie go in reverse, or play in reverse. In a word, we've seen a lot of deflation. Stock and bond prices have fallen, commodity prices have retreated, real estate prices have started to decline. And in the second half of last year, price inflation retreated a lot. And the data on that's pretty convincing that the peak in inflation was mid 2022, and it's fallen a lot in the last six months and likely to keep falling. So this first chart just shows you headline and core CPI inflation on a 12, 6 and 3-month rate of change basis. And the decline is really very well underway. Over the last three months, headline CPI annualized has been about 1.8%. And if we look at core inflation and we take out shelter, which is a big component of the CPI, we have actually deflation. Lots of housing trends suggest that the rental inflation rate is going to retreat over the next year. But just the fact that house prices are falling speaks volumes in terms of what the rental inflation rate might be like in the near future. Survey data did the best job of anticipating the pickup in inflation, and it's telegraphing that the collapse that we've seen in the final part of last year is going to continue this year. And of course, we're due for a blast of deflation from abroad, based on these correlations, which you can see in that chart between U.S. and Chinese producer price inflation. So inflation's peaked. It's falling. It should fall all through this year. And my own view is it's going to be 2% or less.

Katie Klingensmith [00:04:07] So Francis, that's very compelling. And it seems like there are a number of market indicators that also suggest that inflation could be coming down. But the Fed doesn't really seem to have that view. What's going on?

Francis Scotland [00:04:20] It's hard to tell what the Fed believes at times after underestimating inflation so badly last year. The Fed's inflation fighting credibility is really on the line this year. So in the December FOMC meeting, what was really interesting was every single FOMC member believed that interest rates had to go higher this year, notwithstanding this declining inflation rate that I just showed you that was playing out all through the second half. So the Fed shifted its view on inflation from transitory to structural concerns almost at the peak of the price inflation cycle in the middle of last year. And it's really focusing now on how tightness in the labor market and how sticky wage inflation might prop up service sector price inflation. But we know from the yield curve that the market believes that in last year's panicky effort to correct its wrong and get ahead of inflation, that they might have overshot, that they actually overshot equilibrium. Yield curve's inverted. It's been that way for a while now. And even in the Fed's own summary of economic projections, they have an equilibrium fed funds rate at two and a half. So the market's saying the central bank is overdoing it. Conditions are very restrictive. It's not just the yield curve. If you look at the money supply, we've seen an unprecedented contraction in nominal terms in M2, and the contraction in money supply in real terms is as severe as it was in the 1980s. So this is what the yield curve is picking up. Inflation's not going up as long as money growth stays this weak. So if you look at risk assets. Risk assets have been rallying lately. Risk assets are finding optimism in the inflation developments. But because the Fed sees financial conditions as part of the transmission mechanism on inflation, Fed Chair Powell has kept up his sort of hawkish rhetoric. Although lately they've been talking about reducing the pace of the profile that gets you to higher rates as opposed to continuing on 75 basis points a meeting. But there's still no discussion about the case for lower rates.

Katie Klingensmith [00:06:35] Okay. So given the tendency for this Fed to overreact, do you think that there's actually a chance that we avoid recession?

Francis Scotland [00:06:44] Well, that's the million dollar question. I think the Fed has gone--Fed Chair Powell has gone to great lengths to prepare the market, business, and people for the prospect of a recession. He's drawn on references to the Volcker era when it took a really severe recession to break the inflation psychology that existed in the early 1980s. In my opinion, a comparison of that era with today, it just isn't appropriate. You know, we've seen an 18-month pickup in inflation that has largely reversed and is well on its way back to 2%. That's just--there's just no comparison with what we've gone through to what took place in the 1970s and the 1980s. But if the Fed persists in sustaining monetary conditions where they are, we will get a recession. And you can see the underbelly of the labor market beginning to shift here. Temporary employment is already contracting. Average weekly hours have now fallen back to below pre-pandemic levels. Average weekly earnings grew only 3% over the last year, which is a dramatic retreat from the post-pandemic levels we've been looking at. All of that suggesting that the wage disinflation that the Fed is looking for is already in the pipeline. In addition, if you look at some high frequency data, Harvard University has a high frequency economic tracking service which is publicly available, and they track job postings data. This shows there's been a dramatic change in the job market in the last two months, really. Job postings, according to this metric, went from 20% higher than January 2020, as recently as early November, to 20% below January 2020 levels as at the end of last year. So that seems to rhyme with the weakness in average hourly earnings, which was posted in the last jobs report. And a lot of the job layoff announcements that we're seeing in the newspapers, you know, from large marquee-type corporations. Challenger job cuts data pick up some of that. What's missing so far has been a pickup in unemployment insurance claims. But what

history shows is that when UI claims start to pick up, it coincides with a rise in the unemployment rate. And all of that happens very, very quickly, and it's not reversible. So by the time that arrives, it's too late. So will the Fed react fast enough? Given their history and their anxiety about maintaining their inflation credibility, my personal belief is that they probably are not going to react fast enough. There will be another "oh my God" moment, just like there was last year, but in a different direction. So I don't think that the Fed's going to react fast enough. No.

Katie Klingensmith [00:09:45] So that's a lot of uncertainty and a lot of competing forces. Given that, where are you seeing opportunities in duration right now?

Francis Scotland [00:09:54] I think generally speaking, it's pretty constructive for duration. The problem is that the long end of the yield curve is held in check to some extent by the Fed's stubbornness at the short end of the curve. And given how steeply inverted the curve is right now. Fed policy historically is notoriously schizophrenic, it goes from tightening to easing, often without a lot of transition. But this Fed in particular has this characteristic. So I do think there's going to be another, as I said, oh my God moment at the Fed, much like there was last year when they pivoted from maximum stimulus to hitting the brakes. And I think that will come this year. But it may take a labor market dislocation. And clearly, as that arrives, that'll be a big plus for fixed income when it happens.

Katie Klingensmith [00:10:45] That's all incredibly helpful. Thank you so much, Francis Scotland, head of research here at Brandywine Global, for joining me today as part of this discussion, Around the Curve.

Francis Scotland [00:10:53] Thanks, Katie. Have a good one.