Macroeconomic Update

Fourth Quarter 2021

2022: MEAN REVERSION OR WHIPLASH?

More pandemic trauma marked the end of 2021, with Omicron the latest version of the COVID scourge. However, beginning in December, investors began to discount the latest wave as more infectious but less deadly—and possibly the very thing needed to end the pandemic. We hope this view turns out to be accurate. In the meantime, uncertainty persists as long as the threat remains, and a return to normalcy from pandemic trauma still seems off in the future rather than around the corner.

Despite pandemic uncertainty, several economic and financial anomalies created during the past two years appear to be setting up for some degree of reversal, which could be important drivers of investment trends this year. And if these anomalies were to completely reverse, which is not impossible, the outlook for 2022 could be characterized as whiplash.

1. GLOBAL GROWTH SHOULD SLOW SIGNIFICANTLY.

The spectacular surge in growth that began in the second half of 2020 and continued through all of 2021, and particularly in the U.S., is probably over. Government-ordered lockdowns in early 2020 threw the world economy into a contraction more like an apocalyptic natural disaster than any kind of "normal" recession. Correspondingly, the world economy has rebounded out of that economic darkness in varying degrees due to reopenings and Modern Monetary Theory-like policy support in major developed economies. The booming double-digit and high single-digit growth rates staged during this rebound are the arithmetic consequence of a fast rebound back toward pre-pandemic trends—not a normal economic recovery. They are not sustainable. Output gaps have narrowed. The fiscal thrust behind this rebound has now reversed across most Organisation for Economic Co-operation and Development (OECD) countries. Emerging countries have been raising rates to fight inflation. The Federal Reserve has pivoted. In China, where growth is slowing and policy is barely starting to ease, there is no constituency calling for a credit reflation. A slew of leading global economic indicators are pointing lower and purchasing manager-type indexes suggest the trend to slower growth has started.

The relevant question is: How quickly will growth slow and to what level?

2. THE TREND IN INFLATION SHOULD ALSO REVERSE.

Inflation surged in 2021, the biggest economic distortion of all relative to recent history. Global in nature, the extraordinary surge in prices was caused by supply chain disruptions and strong policy stimulus measures in the developed world. American programs supporting income and demand were the most aggressive in the world. Correspondingly, the U.S. was the only major economy to see nominal personal consumption eclipse its pre-pandemic trend, with inflation reaching 30-year highs. In contrast, the rebound in European nominal spending remained short of its pre-pandemic trend, and core European inflation moved relatively modestly to about 2.6% from 1%. Marching to a completely different drummer, China's economy decelerated all throughout 2021, as its policymakers took advantage of the U.S.-led global rebound to crack down on domestic property sector leverage. How the

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economic giants reacted to the ebb and flow of viral infections only seemed to exacerbate the extremes: China's tendency to shut down factories and production colliding with government-supported U.S. spending.

A number of factors suggest the outlook for inflation in 2022 will be lower. The worst of the supply disruptions may be over. Order backlogs are improving, inventories are growing again, and executives of key supply-compromised industries are sounding more optimistic. Both U.S. and Chinese manufacturing prices-paid indicators have started to retreat. U.S. households may be shifting their consumption back to services after a nearly two-year hiatus, supplanting the online binge of consumer durable goods. Rising prices have weakened real income growth and slowed real consumption, and energy costs remain a headwind. But households and business are flush with cash based on money supply trends and accumulated savings; wage rates are rising; and the Fed has only started to pivot.

As with the growth outlook, the relevant question is: How fast will inflation retreat and to what level?

3. NOT YET A CASE OF WHIPLASH, U.S. MONETARY POLICY HAS PIVOTED.

Fed Chair Powell threw in the towel on "transitory" inflation beginning in early November. By mid-December, the stance of the central bank had swung ultra-hawkish with the Fed doubling the pace of balance sheet tapering. At the same time, Federal Open Market Committee (FOMC) members were now openly discussing balance sheet reduction and the prospect of three to four rate hikes.

The speed of the reversal in the Fed's stance is remarkable given its relentless messaging that inflation was temporary. It is not the first time that Fed Chair Powell has folded from an entrenched view. In late 2018, market pressure forced a humiliating reversal in the central bank's stance and Powell's view that the neutral rate was significantly higher. This time around the pressure on the Fed Chair might be more political—the Biden administration's withering popularity due in part to surging inflation. When was the last time a politician asked the central bank to tighten?

Markets have priced in three to four rate hikes by this time next year, with the likes of JPMorgan chief Jamie Dimon and Goldman Sachs spokespersons suggesting more are possible. It would be quite a reversal if all this came to pass. Shrinking the monetary base for an economy in which nominal money growth is rising is potentially very restrictive, unless the money multiplier is rising and bank lending begins to surge. Pressure on the Fed could lift by mid-year with a slower economic trajectory and some improvement on the inflation front.

The question may be: What is the probability of a more extreme reversal in Fed policy than what is already priced in?

4. POLITICS COULD ADD SOME EXTRA TWISTS AND TURNS.

The Biden administration's hopes for passage of its "Build Back Better" fiscal program are faltering due to the conflict between "progressive" and "moderate" Democrats. If Democrats lose control of Congress during this year's mid-term election, Biden's agenda for aggressive fiscal expenditures in the first two years of his mandate will be held up by gridlock in the last two.

Russian and Chinese imperialism remain potential threats to growth, although we view this as more of a tail risk than our base case. A Russian invasion of Ukraine would leave Vladimir Putin in control of natural gas prices and Europe's main energy source; China reclaiming Taiwan would give President Xi control over the West's supply of semiconductors.

These instances, while not our base case, are clearly potential risks to growth.

5. IS THERE AN EXCEPTION TO WHIPLASH?

The one area of the world where there may not be whiplash let alone much mean reversion is China. Policy support during the crisis in 2020 was muted in comparison with the West and quick to be withdrawn. Last year, the authorities took on deleveraging the property sector despite a slowing economy. The People's Bank of China's (PBOC) recent announcement of a 5-basis point cut in the prime rate for one-year loans only drives home the point that they do not want to engineer a broad-based credit reflation. In the meantime, reliance on social isolation to control the virus could compromise growth later this year if Omicron is as contagious in China as elsewhere in the world. The base case for China is a soft landing with the credit impulse bottoming, but the risks are on the downside.

GLOBAL FIXED INCOME—WHAT'S NEXT?

Throughout the past two years, the U.S. Treasury market—anchor to global fixed income—has remained remarkably subdued, considering the surge in inflation. Long bond yields rose to pre-pandemic highs of 2.4% in March of last year before retreating to 1.67% in early November and then finishing the year with a sudden spurt back towards 2%.

For many, the low level of bond yields has been a conundrum. Financial repression and large purchases by the Fed are the most popular explanations. If so, tapering and any subsequent balance sheet shrinkage could boost yields significantly based on this thesis. How far yields could rise or the Fed could tighten without affecting risk assets remains unknown. However, the equity market panic attack last November and early December saw the vast majority of U.S. stocks off by 25% or more, and the indexes propped up by the big-cap growth stocks. This upset seems to be at least one indication that valuations are vulnerable to any meaningful shift in rates, with attendant implications for spending. We doubt that this year's trend reversals from previous years will give rise to a reckoning in the bond market.

It is worth keeping in mind that the conundrum in the bond market persisted for many years before the pandemic. Long Treasury yields were below nominal gross domestic product (GDP) growth rates by as much as 200-300 basis points several times in the last 10 years. Over time, the volatility in this spread has had more to do with swings in nominal GDP growth than long-term yields. Nominal U.S. GDP growth of 5% and the long bond at 2% by the end of the year would return the spread to levels that existed in 2018.

Not to be forgotten, the trend in China's bond market continues to march in sympathy with domestic economic momentum. As 2021 drew to a close, Chinese 10-year yields had retreated to the lowest levels since June of 2020, well below pre-pandemic levels.

On the currency front, the U.S. dollar's resilience has been remarkable in the face of big budget deficits and an expanding current account deficit. There are competing explanations for this performance. Ours is simple: growth. The U.S. has outperformed almost everywhere in terms of rebounding back to or exceeding pre-pandemic trends. The dollar may stay firm until there is a significant shift in this relative performance. Its upside seems limited given our expectation for a ratcheting back in America's growth outlook. However, with the Fed poised to shrink dollar liquidity, prospects for any meaningful retreat may be deferred until later in the year.

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