**Audio Transcript: A Meaningful Swoon in Inflation**
**May 13, 2022**

**Katie Klingensmith** [00:00:02] Welcome, Francis Scotland. It's a pleasure to have you here with us at today's edition of Brandywine Global's podcast, Around the Curve. I'm Katie Klingensmith with Brandywine Global, and it's my pleasure to facilitate this conversation today focusing on inflation. Well, Francis, just let me make sure everyone on the call knows who you are, and we'll jump in. You are the director of Global Macro Research here at Brandywine Global. And I know that you have served in this position, really informing the portfolio managers across the different strategies at Brandywine Global, since 2006. Your insights are important to them and important to all of us. So, let's dive in. You and I chatted at the beginning of this year really looking at trends in inflation, what the Fed was doing, and understanding a lot of different factors at play in the world. And wow, have we spent a lot of time talking about inflation since then. You mentioned at the beginning of the year that this was no ordinary cycle and again, it's less ordinary than it was. A lot has happened. Can we just start by you laying the groundwork as to what has changed in your view since we spoke at the beginning of this year?

**Francis Scotland** [00:01:12] Hi, Katie. Thank you for having me here. Pleasure to see you again. I agree. I think it's really important to emphasize this is not a normal cycle. I don't even think of it as an economic cycle. It's a recovery experience from the profound disaster caused mainly by our reaction to the pandemic. Administered lockdowns, followed by a lot of macro policy stimulus--fiscal and monetary. So, we talked in general terms at the start of the year for the potential of what I called a whiplash effect in the macro economy: booms follow busts follow booms. And this whole idea of supply-side restraints, massive macro stimulus measures and reopenings gave us a pretty sizable boom from mid-2020 to late last year, both in real and nominal economic growth. So, what we were looking for when we talked the last time was some payback or whiplash effects. In some of our more recent work, we've been calling it a hangover effect. So, we were looking for the real economy to slow a lot in the first half of the year, perhaps inflation peak. We talked about it being very stagflationary. You know, I use that term in the context of below-trend growth, above-trend inflation. Something that few people were talking about in January, but it's a lot more prevalent now. And that environment would give way in the second half of the year to some measured, possibly quite a significant, retreat in inflation. So, the main driver for this pullback was mainly the self-equilibrating aspects of the economy. Rising prices caused by both supply problems and excess spending really robbed people and businesses of real spending power. So, with a long lag, we expected this force to slow the economy in the first half of the year, and inflation in the second half. So, what's changed relative to that view that we talked about in January? In my opinion, the basic profile we outline is still the same. If anything, it's probably become more extreme. So instead of a significant slowing in the real economy during the first half of the year, recession seems a lot more possible, if not even likely. China is already in a self-induced recession because of the way it's managing the Omicron outbreaks. We talked about that earlier as a threat to growth but given how highly infectious Omicron is and the Chinese Communist Party's rigid approach to managing the disease, the economy could be on the back foot for quite a while. Fiscal stimulus just really won't work if people can't get out of their house. Europe is already on the verge of recession, if not already in one, owing to the energy-related consequences of the Russia-Ukraine war. So with these major economies positioned that way, it's really hard to picture how the U.S. economy can't experience at least an intense period of softness or weakness, maybe even a brief recession over the course of the next several months with the dollar or the trade deficit really acting as the adjustment valves. That, plus eroding real incomes caused by all this inflation, we think is going to stifle U.S. activity and bring it more in line with what is, at the moment, a pretty dismal global growth trajectory. So now with the Fed focused on reducing price inflation and the real economy slowing, top-line corporate revenue growth is going to slow significantly for a lot of companies. And a lot of cost pressures are going to persist. So, we're probably entering a new phase of the post-pandemic recovery. We have probably reached the stage where corporations can't keep raising prices to protect margins anymore from rising costs. Instead, they're going to actually start cutting costs where they can. Which in a supply crisis, is generally the labor market. All these events, I think, mean that the intensity of the slowdown we talked about in January is going increase. But correspondingly, that means that the prospect for a meaningful swoon in inflation later in the year is also on the table.

**Katie Klingensmith** [00:05:08] Right. You mentioned that so much of this is not about an ordinary economic cycle. And obviously, the Fed is trying to understand and manage all these forces as well. The Fed has become rigorously focused on inflation after last year essentially disregarding inflation as a meaningful concern. Do you think they could overreact with this new focus? And how do we and they know when they've gone too far?

**Francis Scotland** [00:05:34] Great question. The Fed is usually a pretty easy target, but this is really a tough spot for them to be in. The issue is that at least the portion of the inflation we're experiencing is due to supply issues, which are developments beyond the control of the central bank. But conceptually, to keep a

rise in energy prices, for example, from leading to a more generalized increase in inflation and wage expectations, the Fed needs to create offsetting price decreases somewhere else in the system. That's so that the average stays flat. That is enormously contractionary, which was the lesson from the supply shocks in the 1970s and the early 1980s. Those were the worst recessions of the postwar period, and they occurred during a time when the Fed was too slow to react at first, but eventually got ahead of it, but not without creating some really terrible recessions. So, it would be really helpful to the Fed and asset markets if some of these supply-related factors driving up prices and inflation were to improve. But there doesn't seem to be much sign of an early resolution in the Ukraine-Russian war, which is contributing to the increase in energy prices. And President Xi doesn't seem to be backing down from the extreme measures the Chinese Communist Party is taking to control the spread of the virus. So, I think the central bank, the Federal Reserve that is, is very aware of the jam it's in. The pressure on the Fed at the moment is coming from all directions. Politicians want inflation lower. Bond vigilantes would like the Fed to have included some 75 basis point rate hikes to catch up more quickly. But after all of last year's focus on ensuring that the low end of the income curve participated in the rebound from the pandemic and with the midterms coming, there's also a lot of political pressure not to see unemployment rise. In last week's post-FOMC meeting press conference, a number of things suggested to me that Chair Powell is really aware of the tightrope that he's on and the risk of overreacting. So, for example, first he rejected the 75-basis point rate increase as part of the normalization process. So, in doing so, he walked back from provoking a more imminent, possibly larger-scale recession by causing asset deflation, more asset deflation in capital markets. Second, he talked about the need for reducing job vacancies without affecting employment. Pretty obvious he's aware of the potential for those circumstances to drive unemployment higher. And he steered clear of making the case for a big overshoot of the neutral rate, arguing instead that the Fed will see what things look like when they get there. So if the macro playbook I outlined about the economic cycle is correct, the U.S. may be a lot more worried about recession by Labor Day in September this year than inflation.

**Katie Klingensmith** [00:08:26] Well Francis, you did mention that there could be a swoon in inflation, but with all of these different factors, where do you expect inflation to go in the short term? And frankly, you've been talking for a long time about some disinflationary forces that are also at work in the world. What do you expect inflation will do slightly longer term?

**Francis Scotland** [00:08:44] As I said, I think we could see a meaningful drop in the inflation rate, most of which should occur more in the second half of the year than in the first half. There's a few signs that might already be peaking. If you compare changes in core PCE inflation over the last 12 months with annualized rates over the last three months, there's signs of a top. A stand-out comparison is in consumer durable goods inflation, which rose 10.2% over the last two months as follows a two and a half percent annualized rate over the last three. If you recall this particular category, the price deflator in this particular category, consumer durable goods, had been falling. The index has been falling for 25 years before just soaring into the post-pandemic world. So, a retreat in this category could drive inflation significantly lower, as would just energy and commodity prices flattening out, not going down, just flattening out. Which I think is something not unreasonable to expect if real economic growth is as weak in the first half as I am suggesting. Longer term, I don't really think the world has changed that much since the pre-pandemic. We have just been upended by the scale of a collapse during the disaster and the boom which has followed. But overall, I think a lot of the same elements which drove inflation lower still persist. Disruptive technologies seem no less likely. The repression in spending from aging societies in the West and China continues. Debt remains a limiting constraint on the rise in interest rates, hence inflation. And globalization as a force may have peaked. But instead of a wholesale reshoring of production, I think companies are going to continue to sort of seek out the best cost centers in the world for production, although obviously mindful of geopolitics. What I think has changed since the pandemic has been... The pandemic had a very significant impact on labor supply, at least in the U.S. So as deflationary a factor demographics have been from the viewpoint of consumption, they now potentially inject potentially inflationary supply-side consideration. So, I think inflation is going to retreat much lower at the end of the year than where we are now. But I don't believe that the new equilibrium is going to be as low as the pre-pandemic average, which was 1.6 to 2% for almost 20 years. So, I suspect it's going to be potentially higher owing to labor shortages, the Fed's new flexible inflation targeting regime, and to the higher cost of doing business in a world where risk premiums have risen due to geopolitical turbulence. So, I could be really wrong. I don't think 5, 6 or 7% inflation is the new normal. I'm thinking more like 3% plus is more likely to be the scenario that we eventually come out on.

**Katie Klingensmith** [00:11:37] So that's a lot of different factors to consider this year and potentially a very different long term than that which we have known and what 2022 could look like. What does all this mean for bond investors?

**Francis Scotland** [00:11:53] I think it means we're probably close to a top in bond yields, if we have not already reached them, at least for a while. I'm not in the camp that they have to go much higher because

core inflation is much higher than what I'm thinking. So, anyone who has been in this business less than 25 or 30 years isn't used to seeing bond prices and stock prices fall together. Normally, when stock prices fall, bond prices go up. That's the low inflation, slightly deflationary world we've been in for much of the 25 years, up to the beginning of the pandemic. But a positive correlation, falling stock and bond prices was the normal state of affairs in the more inflationary era which preceded that period. So in 2020, we still saw stock prices rise while bond prices were falling, still consistent with this negative correlation of the previous 25 or 30 years. But what took place in the second half of '21 and so far this year has been falling stock and bond prices. Prices of these major asset groups have become positively correlated. And a lot of that has been part of this post-pandemic recovery story. Interest rate normalization, as the economy has surged upward, has resulted in multiple compression across a range of assets whose value is derived from the capitalization effects around interest rates. And that includes equity markets. So, the U.S. equity market has been in a bear market really since mid-October. What I think is beginning to change is that the weakness in the stock market has shifted from a story of multiple compression to beginning of a more depressed outlook for earnings, the recession risk for all the reasons that I talked about a minute ago. So as that risk builds and the real economy slows, reducing the inflation outlook, the bond market should stabilize. Obviously, the dollar is a key part of that dynamic. But both the dollar and bonds have been acting as brakes on the economy. So with the self-balancing nature of the economy kicking in to slow it, the Fed putting on the brakes and corporations beginning to shift to protecting margins by cutting costs, I think the negative correlations are going to reassert. I think the bond market is going to soon stabilize.

**Katie Klingensmith** [00:14:11] Thank you so much Francis Scotland, director of Global Macro Research here at Brandywine Global, for helping us make sense of so many different influences, factors, scenarios as we try to get to the bottom of what inflation might look like this year and beyond. Appreciate your time and appreciate everybody's time listening and watching today.