Macroeconomic Update

Brandywine GLOBAL

Epochal Moments and Hangovers

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Twice in two years, civilization has faced an unexpected existential threat. First, it was the pandemic. Now, it is nuclear war. It all seems surreal and crazy. Hope rises and falls with efforts to negotiate a settlement between Russia and Ukraine and with each wave of the COVID scourge. The reality is that the war continues, and the tail to the pandemic could be long and unpredictable. At the Beijing Olympics, the world's two most powerful autocrats signed a declaration of solidarity toward achieving a new world order. It took Russia's invasion of Ukraine, but the 30 NATO member countries have started muscling up to defend the existing order.

It all feels very unstable, globalization seemingly in retreat. The world order is transitioning from domination by a relatively benign global hegemon, at least from the Western perspective, to a more multipolar concoction of competing ideologies and interests. The late financial historian Charles Kindleberger identified these periods in history as inherently less stable. Buckle up. The instability and volatility are probably here to stay.

From an investment perspective, the political and policy reactions to these events and developments are as important as the events themselves—both in the short and long term. The recent drawdowns in global bond markets, some of the worst in nearly 100 years, are the latest examples. The total return on the 10-year Treasury note fell roughly 10% from its high-water mark in 2021 to the recent low in March. German bund yields are no longer negative. Even the Bank of Japan had to step in to prevent Japanese government bond yields from pushing through their target band.

The scale of the drawdown is noteworthy, given the modest rise in yields. The yield on the Treasury long bond is only about 20 basis points (bps) higher than a year ago. But the effect of low yields on extending duration is to intensify the price reaction to any rate change. This asymmetry may partially explain why the forward yield curves are flat or inverted. Mean reversion tendencies suggest at least a pause after drawdowns of this scale. These increases have brought bond yields in many developed countries to the upper end of the 40-year trends defining the secular bull market. Is this the beginning of the end? Or the end of the beginning?

The cause of the bond blowout is complex: the most aggressive policy stimulus measures in peacetime history—at least in the developed world—colliding with pandemic and now war-induced supply constraints and a related energy shock. The result has been booming *nominal* growth conditions in many countries and the highest inflation rates in decades.

By the end of 2020, most of the world economy was rebounding rapidly out of the economic hole created by the lockdowns. However, measures taken in 2021 varied around the world with consequential outcomes, including the following:

- Near the end of 2020, Chinese authorities began pulling back their relatively

small pandemic-related fiscal policy stimulus while the People's Bank of China normalized money market rates quickly. Chinese bond yields peaked in November 2020 and have been falling fairly steadily ever since. Headline Consumer Price Index (CPI) inflation is less than 1%. Producer price inflation did surge dramatically to over 13% but has been falling since last October.

- During 2021, central banks in many of the lesser-developed and emerging countries of the world moved aggressively to reverse the rate cuts of early 2020. Several South American economies in particular saw policy rates increase dramatically, well above pre-pandemic levels. The forward actions of these central banks help explain why there has been no taper tantrum as the U.S. Federal Reserve (Fed) now pivots to restraint.
- The developed world went in a different direction during 2021, led by the Biden administration. The American Rescue Plan pumped another $2 trillion in government spending programs directly into the U.S. economy for a cumulative total in pandemic-related fiscal support of $7 trillion, according to Bank of America analysts. The Fed—unlike its counterparts in China and the emerging world—flooded capital markets and the economy with a relentless torrent of liquidity up to and including almost the entire first quarter of this year. These aggressive demand measures drove U.S. CPI up to 8% from only 1.7% as recently as February of 2021. German producer price inflation has risen to its highest level since 1948.

Hangovers are more severe the more alcohol you drink, and there has been a lot of heavy drinking in the U.S. in economic and financial terms. The Fed was still spiking the punch bowl in March despite inflation soaring. The unusual fiscal libations cumulate to an inebriating 30% of 2019 gross domestic product (GDP) and only ended last September. There are no historical comparisons of this magnitude, or with this number of actions, other than times of war. It is hard not to conclude that the additional macroeconomic stimulus provided in 2021 was a policy mistake of colossal proportions.

How big will the hangover be? What will the withdrawal symptoms look like? What will things look like after the hangover passes?

Booms follow busts, which follow booms. In January, we discussed the possibility of economic whiplash. Namely, we suggested that last year's trends could reverse this year, and the reversal could be significant, even undoing much of those trends. This scenario still seems the case, although how big a pivot in macro policy that occurs and how markets adjust will affect outcomes. Some indications of these reversals include the following:

- Sooner rather than later, we expect attention in the U.S. to turn from worries about inflation to worries about the economy. Europe is probably already in a recession. China, trying to pull out from a growth profile that is too slow, is now fighting the headwinds of another viral surge in areas affecting 78% of its GDP.
- U.S. *real* final sales are already slowing sharply—leaving stagflation in their wake. *Real* retail sales have been flat for a year. *Real* durable capital goods orders—a good indicator of capital spending—have been flat since September. Rising inflation is eroding real purchasing power, which is why the Atlanta Fed GDPNow model has real GDP growth at barely 1% this quarter, and why wage demands are on the rise.
- There could be a measurable retreat in U.S./Western inflation later in the year, depending on trends in commodities and energy, the latter made worse by the fallout from sanctioning Russia. How low inflation might retreat is still unclear because of wage and employment trends. By some estimates, the current labor market is the tightest in recorded U.S. history, which suggests that a return to the pre-pandemic inflation backdrop might not be possible.
- Much will depend on the Fed, which has finally decided to reverse course, although how abruptly remains to be seen. Powell has blundered twice in his tenure as Fed chair: first in 2018, believing the neutral rate to be much higher; and last year, hanging on to the "inflation as transitory" view too long. The new risk is that Powell pivots too hard in the opposite direction as he tries to catch up. The market is expecting 2.5% for the federal funds rate by the end of the year. The big known unknown is the impact of simultaneously shrinking the Fed's balance sheet. It is hard to say what will happen as it is reduced, but we doubt that the runoff will be as benign as Powell suggests. That might be another reason for the flat/inverted shape in the forward Treasury yield curves.

Dollar Hegemony

In comparison with the Fed, China's central bankers look like a bunch of stingy teetotalers; there was not even the faintest sign of a reflationary pulse in February's M1 report. Nonetheless, it seems inevitable that more incremental steps will follow the measures already taken, which should build into a significant wave of stimulus successive approximation that grows all year. The economy had already slowed enough for policymakers to retreat from "common prosperity" measures last year, as well as from measures to reduce leverage in the property sector. This year's lockdowns to contain the latest viral surge have created another growth headwind. President Xi is looking to be renominated later this year, so both economic and political factors argue for much more stimulus.

A more strategic motivation for economic stimulus is the draconian scale of the developed world's financial sanctions against Moscow, and in particular, the confiscation of state-owned and private assets. These measures undermine the fundamental belief that Western assets are "safe." China holds $3.2 trillion in foreign exchange reserves, with 50% still denominated in dollars. Given the Chinese Communist Party's position that reclaiming Taiwan is nonnegotiable, it is logical to assume that China's leaders believe they will face similar sanctions at some point in the future.

What China can do about this vulnerability is not obvious, especially given its dependence on the West for exports. There are few alternatives to the dollar or Western assets at the moment. China could allow its currency to become convertible, but that would risk a major realignment of domestic asset prices and interest rates. Converting to gold or fixing the currency to gold might turn out to be too expensive, as well as lead to a lot of volatility in the real economy. Alternatively, the Chinese need to reduce the accumulation of reserve assets by shrinking the current account. Ideally, the authorities would like a lower household savings rate, but the most expedient way to reduce reserves or the current account in the near term is by more government dissaving—or stimulus.

None of these outcomes seem particularly bullish for the hegemonic life expectancy of the greenback, given the dollar's foundation of endless deficits, soaring inflation, distribution-focused policy instead of growth-focused, and a carbon-neutral agenda that rewards autocratic producers of oil and gas in the world at the expense of more responsible domestic producers. Yet as unpredictable as forecasting the dollar's demise may be, it does not look imminent. Its resilience is remarkable considering the flood of dollar liquidity during the past year and the widening current account. It may be that geopolitical volatility favors the dollar for the time being. Dollar stability is crucial to anchoring nominal bond yields, along with medium-term inflation expectations.

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