Macroeconomic Update

Brandywine GLOBAL

Policy Mistakes and Riot Points

Francis A. Scotland
Director of Global
Macro Research

The worst global bond bear market in a century found no relief during the third quarter. Things just got uglier. With U.S. Treasury yields seemingly going parabolic from their base in 2020 and much of the world economy teetering toward or already in recession, it is important to understand what is behind the inflationary mess driving the fixed income bust and the implications for what lies ahead.

We still think inflation remains closely linked to the pandemic and the historic but mistaken stimulus provided by public policy. Last year's errors in judgment regarding the transitory nature of inflation have since driven central bankers in North America and Europe into panic mode. The frenetic effort to catch up and get ahead of the inflation curve means that the risks of a mistake in the other direction are growing. Complicating the manic swing in monetary policy is fiscal policy. European governments are struggling with fiscal offsets to the energy crisis while the U.S. government has passed spending bills aimed at loan forgiveness and greening the economy.

The markets, financial system, and the economy have limits. And we are getting close to them. Tightening led by the Federal Reserve (Fed) usually ends with a financial crisis, which leads to a credit crunch and recession. We had a whiff of a potential crisis from the U.K. late in the quarter. The British government's latest plans to hit the gas with fiscal policy and pump the brakes with monetary policy provoked a lenders' strike severe enough for the financial stability arm of the central bank to rein in bond yields, effectively neutering the broader monetary goal of lowering inflation—at least temporarily. The current course of British economic policy is unsustainable. It is complicated, but news of U.K. pension fund vulnerability to liquidationist pressures caused by the drop in gilt prices, which are down almost 50% over the year, could be a warning sign of bigger financial fragility issues beneath the surface—and not just in the U.K.

All this suggests that capital markets are moving toward riot points. A riot point usually refers to a configuration in economic policy, the economy, and the financial system that triggers a sudden and large outflow of capital from risk assets as investors lose confidence in the outlook for economic and financial stability. Riot points are often associated with or followed by policy pivots.

Central banks seem chained to a Fed-led death march of rapidly rising rates to bring inflation back to target. A few, like the Bank of Canada, Reserve Bank of Australia, and Norges Bank, have blinked. They may be worried about their massively overleveraged housing markets. Interventions elsewhere—whether from efforts to stabilize the Japanese yen, Chinese yuan, or British gilts—are indicators of growing stress. We think something is probably going to break soon owing to the cumulative lagged effects from this rapid tightening in financial conditions.

Seeds of the Bond Bust

The 2020-2021 boom in the U.S. witnessed a surge in nominal gross domestic product (GDP) not seen in decades. *Real* GDP had a V-shaped recovery, coming out of the hole created by the lockdowns and returning to its pre-pandemic trajectory of roughly 2%; *nominal* GDP, however, kept exploding higher. So, most of the policy stimulus bled into higher prices; the bulk of the inflation shock has been more a case of too much money and spending than too little supply. Bond yields, which plumbed historic lows in the depths of the post-pandemic bust in 2020, have risen ever since and accelerated higher this year.

Recapping the sequence of events that have brought us to where we are today:

- It started with massive Modern Monetary Theory (MMT)-like public policy implemented to spare the economies of the developed world from the effects of government-mandated lockdowns. The result was historic fiscal expansion fully funded by open-ended balance sheet expansion from the world's most important central banks.
- Money supply growth exploded and, with a lag, so did inflation.
- The V-shaped recovery was ignored by policymakers, and the Fed played down inflation, a by-product of supply chain problems and re-opening demand. Commodity and goods prices were soaring, but lagging indicators of inflation, like wages, rents, and service sector inflation, remained relatively behaved at first.

Seeds of a Different Bust?

It is obvious the Fed made a big mistake last year and has pivoted this year. The U-turn in policy exposes how asymmetric the U.S. central bank's policy has become and why the current asymmetry means risks have swung from inflation to recession.

- Last year the Fed's bias was a misguided preoccupation with employment. It closed its eyes to exploding money supply, a positive yield curve, increased commodity and energy prices, asset inflation, a booming housing market, growing market inflation expectations, and official reports of rising inflation.
- This year the Fed's bias is in the other direction: determination to bring inflation back to target. But once again the Fed seems blinded; only, this year it is to the reality that all of last year's inflation signals have reversed. Money supply growth has collapsed, the yield curve is inverted, market-based real yields are at the highest level since 2009, commodity and energy prices are falling, the dollar is surging, asset markets are deflating, housing is in recession, breakeven inflation rates are falling, and leading indicators show inflation retreating. Core personal consumption expenditures (PCE) inflation is lingering at a high level, but it most likely peaked in February, even before the Fed's first rate hike.

For the moment, the U.S. economy is holding up relatively well despite the recession in housing. The economy was in technical recession in the first half of the year, but underlying real demand has been positive with the Atlanta Fed's GDPNow forecasting third-quarter growth at close to 2.3%. In our view, the U.S. economy is still trying to renormalize post-pandemic and looking for equilibrium in the wake of lagged effects from monstrous policy shifts. Contraction in the Conference Board's leading economic indicator implies recessionary forces continue to build. Real personal consumption has been fairly flat the past year while nominal spending is strong but slowing. Sentiment is horrible because of high prices, but household balance sheets have benefited from cumulative savings. So far, consumers have been willing to reduce savings rates to sustain nominal personal consumption growth at an 8% annualized rate this year. Meanwhile, nominal personal income growth has been running at closer to a 5.6% rate. Real disposable income, however, has stagnated, while real personal consumption has expanded at a 2.3% annualized rate.

There is still the possibility of a Goldilocks outcome if prices/inflation retreat enough with limited weakness in the labor market. But the odds of recession are growing given the Fed's haste to push rates higher without taking the time to calibrate their impact.

Unfortunately, the rest of the world is in worse shape, leaving the global economy exposed to the stress imposed by tighter dollar liquidity conditions and dragged along by the Fed's desire to weaken employment. A review of global conditions shows that:

- Europe is already well on its way to a deep recession provoked by the double-digit increases in gas and electricity prices. The deterioration on the Russia-Ukraine war front only compounds the loss of confidence. The European Central Bank—whose only mandate is inflation—is now tightening into the contraction. The economic stress is visible in the small but economically sensitive high yield credit market where spreads have reached levels seen during the Global Financial Crisis.
- The world's second-largest economy remains relatively stagnant, a by-product of China's zero-COVID social isolation policies coinciding with efforts to remove speculation from the property sector. There are reportedly 300-400 million Chinese citizens under some form of lockdown measures, hindering the efficacy of counter-cyclical stabilization measures. A slow implosion of the real estate sector seems to be unfolding with the authorities resisting oversized stabilization measures under the maxim that "housing is for living, not for speculation." There is also an overwhelming desire not to re-leverage the system. Furthermore, China's labor force is contracting, and President Xi is retaining his predilection for control over liberalization of the economy, neither of which are long-term positives for the property sector or the economy in general.

Global leading indicators are universally negative and suggest that the world economy is entering recession. Independent research suggests that global real estate prices may have started to retreat. Everything that went up during the boom phase of the pandemic now seems to be going down, except employment and inflation, which are lagging indicators, and interest rates...at least for now.

Inflation: How Structural?

Much of the outlook still boils down to the question of how sticky inflation proves to be. A decline seems inevitable but when, how fast, and how far? A lot of comparisons have been made with the 1970s, however, we do not think this environment is the same. There are structural elements to the current inflation outlook, but they are hard to measure and handicap:

1. **The energy crisis:** A supply shock reminiscent of the OPEC shocks of the 1970s underscores the current stagflationary character of the developed world economies. The difference this time is that the Fed is cognizant of that era's tendency for policy to ease too soon into a contraction and allow stagflation to bleed into ever-rising inflation expectations. Unfortunately, fiscal policy is not making this situation any easier, with the U.K.'s recent experience the most visible example. Empowered by the scope and scale of intervention during the pandemic, Western governments seem limitless in their willingness to write checks to compensate for exogenous shocks—the latest being the rise in food and energy prices. This behavior will use up excess savings and could partially explain why real yields have spiked.

   Perhaps less of a concern, at least in the long run, is the difficulty for supply to respond to the energy shock because of enviromental, social, and governance (ESG) related resistance to the expansion of hydrocarbon fuel sources. However, the realities of approaching winter amid an energy crisis have governments around the world reopening coal and hydrocarbon-fueled power plants. Led by Japan, many are turning nuclear plants back on, deferring decommissioning, and embracing new nuclear technologies as an environmentally safe path out of the crisis.

2. **Labor supply:** The U.S. economy has emerged from the pandemic with a smaller work force, due mainly to a surge in boomers retiring. This demographic shift is a supply shock, which if accommodated by monetary policy, would be inflationary. So far, the Fed's behavior seems at odds with a potential accommodation, but it suggests that real pain in the economy likely is coming if the central bank is serious about softening the labor market.
3. **War:** The West is effectively at war with Russia through its efforts to support Ukraine. Wars are many things, and the latest threats for a potential nuclear escalation in the Ukraine/Russia conflict is disturbing to say the least. But wars are also inflationary by creating a need for government spending, which boosts aggregate demand—a "guns and butter" macroeconomic conflict. Weaponizing energy and commodities also creates more potential for stagflation, particularly if governments try to inoculate their economies from the added costs.

Elsewhere, the hostility between the U.S. and China, the world's two largest economic powers, is growing. While the situation has not broken into a hot war, cold war pressures are building, which are generally not good for reduced costs. Capital spending has been picking up in the U.S., possibly an early sign of re-shoring, which would increase the economy's cost base in the interests of security. There are many stories of multinationals diversifying production away from China to other areas of the world in the hope of achieving security through diversification while maintaining a low cost base.

How Will It Play Out?

Inflation lagged the economic cycle on the way up and will lag it on the way down, notwithstanding the structural arguments for inflation. The only question is timing. We think we are very close.

It is not a normal cycle, and the world is in or close to a global recession. But policy asymmetry, tight labor markets, and lagging inflation reports press the monetary authorities to keep at it. Many indicators at this juncture are telegraphing lower inflation, which so far, are not ratified by the official data. Global real estate price indicators are teetering. U.S. housing is in recession. It is hard to see why the corporate sector will not want to cut costs in a big way with the cost of capital skyrocketing. Breakeven inflation rates, retreating most of the year, dropped meaningfully near the end of the third quarter with the 30-year breakeven rate only a few basis points above 2%. It is difficult to comprehend how all these pressures do not turn deflationary over the course of the next 12 months. Energy and commodity prices as usual will be wild cards.

The unusual nature of the cycle reflects macro gyrations associated with the pandemic, big policy mistakes, and the whiplash effects that we have been talking about all year still in play as major dislocations revert. The economic boom of 2021 has already given way to slower growth with the latest U.S. ISM data pointing to stagnation or worse; the global economy is likely already in recession. The hyper-expansionary and procyclical stance of monetary policy in 2021 has flipped to a hyper-contractionary stance in 2022, with the Fed tightening liquidity in a world already in recession.

Our view is that last year's policy overreactions are being repeated this year but in the opposite direction. The result of last year's mistakes was inflation. The cumulative effect of this year's restriction in financial conditions is yet to be fully expressed. However, with the world teetering into recession, something is likely to break soon.

The views expressed represent the opinions of Brandywine Global Investment Management, LLC and are not intended as a forecast or guarantee of future results. All information obtained from sources believed to be accurate and reliable. Fixed income securities are subject to credit risk and interest-rate risk. High yield, lower-rated, fixed income securities involve greater risk than investment-grade fixed income securities. There may be additional risks associated with international investments. International securities may be subject to market/currency fluctuations, investment risks, and other risks involving foreign economic, political, monetary, taxation, auditing and/or legal factors. These risks may be magnified in emerging markets. International investing may not be suitable for everyone. Brandywine Global believes that transactions in any option, future, commodity, or other derivative product are not suitable for all persons, and that accordingly, investors should be aware of the risks involved in trading such instruments. There may be significant risks that should be considered prior to investing. Derivatives transactions may increase liquidity risk and introduce other significant risk factors of a complex character. All securities trading, whether in stocks, options or other investment vehicles, is speculative in nature and involves substantial risk of loss. Characteristics, holdings and sector weightings are subject to change and should not be considered as investment recommendations. All data current as of the date at the top of the page unless otherwise noted. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. **Past performance is no guarantee of future results.**

©2022, Brandywine Global Investment Management, LLC. All rights reserved.

Brandywine Global Investment Management, LLC

1735 Market Street
Suite 1800
Philadelphia, PA 19103

BRANDYWINEGLOBAL.COM

AROUNDTHECURVE.COM