Macroeconomic Update

Brandywine GLOBAL

Self-Preservation and Credibility

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Welcome to 2023 and not soon enough. Last year delivered negative returns across most asset classes, not to mention the worst global bond market rout in a century. Even cash failed to keep pace with inflation.

The bad news is that the new year kicks off with a slew of last year's known unknowns still unresolved. Will the Ukraine-Russia conflict turn nuclear? Will U.S.-China tensions escalate? Where will the drive to net-zero greenhouse gas emissions take energy prices? What is next for COVID-19? Will China's U-turn on policy be enough to stabilize the economy? Will the Federal Reserve (Fed) overreact? Handicapping these unknowns remains difficult.

What we do know is that a very unbalanced world economy entered the new year close to or already in recession. China was by far the weakest of the major economic blocs and quite deflationary. Still early days, the Chinese Communist Party rang in the new year with a dramatic U-turn in policy: an abrupt and chaotic end to its zero-COVID strategy and a blitz of growth-enhancing measures. In contrast, the U.S. entered the new year with the Fed hitting the brakes hard while offering a lot of tough talk that the fight against inflation will be bloody enough to cause recession. The world's two largest economies seem set up for exactly opposite economic cycles this year.

It is a complicated and fragmented collection of developments and prospects, but several themes seem likely to define this year's macroeconomic road map and drive investment returns. The net of these factors calls for a disinflationary and soft first half of the new year; what happens later depends on the dynamics in the U.S. and China and the credibility of their policy leaders.

Federal Reserve Credibility

This is not your normal business cycle. We still see economic developments as reflections of an economy attempting to normalize from a disaster while simultaneously adjusting to extreme swings in economic policy. It is possible that we are coming to the end of this process in 2023.

- Government-mandated lockdowns pushed the U.S. economy into the deepest contraction since the Great Depression of 2020. However, the economy quickly rebounded on reopenings and then was chased dramatically higher with massive Modern Monetary Theory (MMT)-like fiscal and monetary stimulus. The combination of reopenings and historic stimulus sent money growth soaring along with financial asset, commodity, and real estate inflation. The economy boomed, and with a lag, so did price and wage inflation.
- Most of this booming recovery was ignored by the Fed. As recently as December 2021, the Federal Open Market Committee (FOMC) Economic Projections showed that the median FOMC member anticipated a meager 80-basis point increase in the

federal funds rate for 2022 and a retreat in inflation to well below 3%. By March 2022, only three months later, the CPI inflation rate had risen 8.5% from the previous year and almost 11% over the previous three months (annualized).

The Fed has a credibility issue. It is obvious that the central bank made a big mistake in 2021, underestimating the momentum behind inflation. It finally realized its error in March last year with its panicky U-turn. Since flipping, the Fed has presided over the fastest run-up in policy rates over any comparable period in its history while simultaneously shrinking the balance sheet. The dollar soared as the Fed tightened into a global economic downturn. Research from the Federal Reserve Bank of San Francisco calculates a shadow federal funds rate that takes account of the balance sheet and financial conditions. This measure has risen almost 700 basis points from its low.

What has happened since the Fed's pivot in March?

In a word, deflation.

Like watching a movie backward, everything that went up during the boom phase of the pandemic has been coming down and in sequence: across-the-board asset prices are deflating; industrial and energy commodities are in retreat; real estate prices have started to fall; and not only inflation rates but price levels are declining in a range of goods. The broad economy has remained supported by consumption, which, in turn, has been propped up by a drawdown of accumulated savings from the earlier fiscal stimulus. However, deceleration is evident almost everywhere in both real and nominal terms. Broad price inflation measures have been rolling over. U.S. headline Consumer Price Index (CPI), which peaked at 9% mid-2022, rose less than 2% over the last six months of data (annualized). Furthermore, survey data suggest lower inflation rates ahead, and there is a clear fall-off in nominal income growth evident from the latest labor reports.

In the meantime, Fed stringency has reached a level not seen in decades: real money supply growth is lower than any time since 1980. Nominal money supply growth is contracting for the first time ever. Commercial bank lending standards are tightening.

Despite these developments, the FOMC is acting as if it is blind to signs of retreating inflation as it was to signs of escalating inflation a year ago. Virtually every member of the FOMC signaled in December that rates need to go higher this year. But based on the yield curve, the market is not buying it.

The intransigence of the central bank definitely increases the probability of recession, with the majority of economic forecasters suggesting one is already in the pipeline. With its credibility at stake, the Fed may have no option but to bombard the market with talk of persistent tightening. Otherwise, acknowledging the retreating nature of inflation too soon could invite a powerful rally in risk assets, which could put the Fed and the economy back in the same boat six months from now. However, if inflation falls as quickly as some current trends suggest to us, it is hard to believe the Fed would not react to these developments earlier. With oil prices down 40% from their peak, some of the "stagflationary" forces have reversed. Putting it all together, a timely response by the Fed to easing inflation could produce a shallow recession or soft landing. Unfortunately, the track record of intransigence implies it could take something more or some event to shift the Fed's position.

Chinese Communist Party (CCP) Credibility

It should be obvious that the suite of policies promoted by the CCP under the direction of President Xi has been a big mistake, the credibility of the Party and the President taking a big hit. The policy reversals underway will not be temporary, notwithstanding their vulnerability to political whims of the party strongman. Extreme economic weakness, property sector deflation, and the population's fatigue with the nonsensical COVID policy erupted into rare criticism and protests that are an existential threat to the current regime. The authorities have been forced to act.

The CCP has thrown in the towel on the zero-COVID policy championed by President Xi himself and now seems determined to get it over with as fast as possible. How the public reacts to this dramatic reversal remains to be seen. For three years they have been warned endlessly about the dangers of this disease. To go from that to complete laissez-faire in the blink of an eye has been incredible. More protests and criticism are certainly possible, depending on the number of deaths from the virus, although an accurate assessment of the pandemic trends or death rates may never be fully disclosed by this authoritarian regime.

President Xi has also taken the property sector off his hit list and put it on the help list. There are reports that the authorities are preparing to relax restrictions on developer borrowing and dial back the "three red lines" policy, the financial regulatory framework introduced in 2020 and aimed at reining in the property sector excesses. In addition, government officials are talking up business and the private sector after previously stifling them over much of Xi's rule. China has placed orders for Australian coal, suggesting that even its foreign policy is shifting. All these developments imply China is pulling out all the stops to stimulate economic growth.

Property price deflation has directly impacted the Chinese household, with real estate making up roughly half of household net worth and 25% of economic growth. Weakness in the property sector also has undermined provincial governments, which depend on land sales and debt funding for financing. The threat of provincial defaults was rising amid reports of government employees in certain provinces not being paid for months. Lastly, weakening U.S. imports of Chinese goods knocked the one leg out from under the economy that was providing support.

Observing all these developments, our bias is to believe that the authorities will be successful in encouraging a rebound in the Chinese economy. The CCP needs to see growth. Plus, Chinese households are sitting on a potential tinderbox of accumulated savings, which would provide added spending firepower—provided confidence returns to the population, which is no guarantee. A second COVID wave is expected in May/June, which may stall any rebound in confidence. In addition, we suspect there must have been some behind-the-scenes turbulence in the upper echelons of the CCP, given how opposite the new policy initiatives are to those personally championed by the president himself. Instability in leadership is never a positive for an economy.

The Global Economic Profile

How do all these factors play out for the global trends that drive markets? The world's two largest economies appear to be on completely opposite cycles: one stimulating and gunning for growth; the other very restrictive and prepared to incur a recession for the sake of reducing inflation.

Sequencing will be important. Most leading indicators predict a softening in U.S. economic trends well into the year, based on what the Fed has already done, and further if the Fed continues to tighten. If inflation falls as fast as we suspect, and the Fed pauses, the growth slowdown would be more shallow but still slower for most of the year.

In China, signs indicate that the pandemic may have already peaked across a range of big cities. How people react is unknown, particularly with another wave expected in May/June. After years of indoctrination about the hazards of this virus, it may take a while to regain confidence. The measures to stimulate the economy are only beginning, and the scale of support required to turn the property sector around will have to be substantial.

Netting it out, the first half of 2023 looks like it will be fairly disinflationary for the global economy, with spending and growth looking quite weak over the first six months of the year. Markets may front run the trends discussed here, but actual traction in the real economy, particularly in China, may not develop much momentum before the second half of the year.

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