Macroeconomic Update

Brandywine GLOBAL

Monetary Deflation and Tail Risks

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Monetary lags are long and variable, but we think we have reached an inflection point. Things are breaking. Last year it was cryptocurrency and multiple compression across asset markets; this year it has been stress events in the banking system.

As the saying goes, monetary cycles rhyme. Tightening episodes end when something breaks; there is a crisis, which is followed by a reflexive withdrawal of credit and often recession. Every cycle is different, but the crisis does not end until there is at least a pause in tightening, if not a retreat.

We do not know whether the stress events during the first quarter represent the beginning of a systemic crisis and the start of something bigger. And it is hard to know how to handicap the outcome of policy efforts to reverse an inflationary bubble caused by one of the worst fiscal and monetary policy errors in history. Back-testing in this environment is no option. Historical overlays could be more misleading than helpful.

What is clear and what is driving our fixed income positioning at Brandywine Global is the breadth and scale of the monetary deflation unfolding around the world.

- In the U.S., the yield curve inverted last November, using the federal funds rate and 10-year Treasury note, a signal by the market that Federal Reserve (Fed) efforts to correct its inflationary mistake have gone too far. Nominal money supply is contracting as deposits flow out of the banking system. Private credit growth has been contracting since June 2022, adjusted for inflation. Willingness to lend from commercial banks has been retreating. Commercial bank lending contracted over $100 billion near the end of March and the most recent developments in regional banking make the case for chronically weak lending ahead. Regional bank lending has been a big driver of loan creation in recent years and is particularly significant for commercial real estate, a sector where there is significant turbulence. Broad measures of inflation are already in retreat, even though the bulk of the lagged effects from tighter monetary policy are yet to be realized. Despite these trends, the Federal Open Market Committee (FOMC) is laser-focused on the stickiest inflation segment of the household sector's consumption basket and sees higher unemployment as the only path to lower inflation. The central bank has made no bones about its willingness to err on the side of too much tightening to restore its tattered credibility on inflation.
- The monetary situation and credit profile are just as bad in Europe. Narrow money balances contracted again in February, pushing negative growth rates in nominal M1 money supply to new lows. Real money growth is significantly lower, owing to Europe's high inflation rate. Nominal credit growth to euro area residents collapsed to zero early in the year, the stock of credit stagnating in recent months. As a result, Europe's credit impulse has retreated on a scale comparable to levels reached during the sovereign debt crisis in 2011-2012. Banking is a far more important source of financial intermediation in Europe than the U.S. Much like its U.S. counterpart,

the European Central Bank (ECB) remains focused on headline inflation, which is retreating but still higher than in the U.S.

- China is not trying to tighten economic policy, but its monetary profile is surprisingly subdued, given all the speculation about how post-pandemic reopenings would lift the economy. There has been little growth in M1 money supply since June of 2022, and currently, the 12-month change in China's credit impulse is barely positive. The three-month Shanghai Interbank Offered Rate (Shibor) has risen about 90 basis points as the economy re-opened. Property sales are recovering, but it is a sector that the authorities do not want to pump up. As for inflation, there is none. Headline Consumer Price Index (CPI) inflation is 1% and falling; core CPI is 0.6%. Producer price inflation is -1.4%, implying that China's real short-term interest rates are among the highest in the world. U.S. import price inflation from Asia is zero and collapsing.

A Lot of Moving Parts: What Next?

What is the endpoint for all this monetary contraction? How does it play out? What does it mean for how we position our fixed income portfolios? *It seems intuitive that at some point all this monetary deflation translates into price disinflation if not deflation, which is clearly supportive of the bond market.* But how and when we get there is less obvious.

We continue to emphasize that what is playing out is an economy still normalizing from a once-in-a-lifetime event: it is not a normal cycle or business expansion. And it is not a normalization back to what was. It is normalizing around something different. There are a lot of moving parts that make things complex. For example:

- Consumption rocketed higher into goods during the early phase of the pandemic and later shifted to services as things reopened. Most believe that the extra savings stockpiled during the pandemic provided a lot of support to consumption. Correspondingly, there is a lot of speculation that spending could cool rapidly as this stockpile shrinks.
- Goods prices led inflation on the way up and are doing the same on the way back down. Service sector inflation was slow to rise initially and has been slow to fall in the descent. U.S. labor force shrinkage complicates the inflation outlook because wages should rise relative to other factor costs, but this wage growth by itself is not necessarily inflationary.
- Parts of the U.S. economy are already in recession, like home sales and manufacturing. Auto sales on the other hand are picking up, and U.S. personal disposable income growth is expanding at close to a 10% annual rate. The labor market has normalized, according to Bureau of Labor Statistics data, with participation and employment rates in the 25-54 age group back to pre-pandemic levels, suggesting that most of the prime-age workers are back in the labor force. Nevertheless, job openings—while retreating—are still in excess of previous cycles.
- Panicky policy moves exaggerated the renormalization phase. Fed easing for too long contributed to the inflation rebound. The panicky effort to fix its own mistake could lead the Fed to an overshoot in the other direction.
- The burst of fiscal spending that drove things on the way up is over. However, politicians' lust for government largesse has been difficult to rein in during the rebound phase, a tendency that could drive equilibrium real interest rates higher than pre-pandemic levels, affecting the neutral rate.
- Regional diversity in policy response is another complication. Unlike the U.S. and Europe, China abstained from big macro support for its economy and only reopened this year. Its policymakers remain on the sidelines waiting to see what becomes of consumption given the large cash cushions and potential pent-up demand in Chinese households.
- The price of energy is a major wild card. The rise in the price of oil from 2020 to its peak in early 2022 was partly responsible for the stagflationary economic profile during most of last year. Oil prices have retreated 35% since then, the swoon in West Texas Intermediate (WTI) crude oil to below $70 per barrel in March quite astounding. Either the world economy is steadily weakening or it might be Russia pumping oil aggressively to shore up deteriorating finances. Natural gas prices are off 80%. If rising energy costs mean stagflation, then falling energy costs should translate into a low inflation expansion.
- Geopolitics—a big known unknown. So far, escalation is the only descriptor for the Russia-Ukraine war. Where does it end? U.S.-China tensions are reaching Cold War status. Meanwhile, America's technology embargo was an official declaration of the end of U.S. efforts to help and encourage China's integration into the global order. Instead, the U.S. is working to maintain the global order it created and has adopted new industrial policies to secure supply chains. China, on the other hand, is making no

attempt to conceal its best efforts to create an alternative financial/economic ecosystem that reduces its vulnerability to potential U.S.-led sanctions against any countries that do not play by the rules of the old world order.

Normalization, the Yield Curve, and Tail Risks

Which breaks first? The economy or inflation? Our base case has been the latter. Post-pandemic normalization suggested to us that economic growth could muddle along, giving enough time for inflation to break low enough for the Fed to ease off the monetary brakes. The case for that scenario has been the combination of monetary deflation, the excess savings still held in households, and corporate cash levels. Another positive might be labor market flexibility: wage inflation has retreated from its peak, but more needs to happen. A lot of indicators point to recession, but our view has been normalization might instead result in adjustments rolling through different parts of the economy at different times, which appears to be happening at the moment. Under this scenario, the year could possibly end with the shallowest of recessions or below-trend but positive growth as the economy reboots itself back toward non-inflationary expansion. The muddle-through scenario is conditional on inflation breaking before the economy and on the Fed not squeezing too hard in the interim—or prematurely easing. It is a positive scenario for risk assets with the retreat in inflation supporting bond prices. Where bond yields settle out would be driven by what is neutral, which is yet to be determined but probably not much lower than where yields are currently if the end point is an environment of 2% growth and 2% inflation.

The easiest way to frame the tail risks to this "muddle-through" scenario is to consider what normalization means for the Treasury yield curve. Normally, the curve is positively sloped, which means getting there from the current configuration requires lower short-term rates or higher long-term rates or some combination of the two.

- The case for yield curve normalization due to higher long-term bond yields hinges on inflation not falling as much as expected. U.S. market-based inflation expectations are clustered around the 2.2% to 2.4% range. Bond markets could be vulnerable if the Fed was to react to an event, such as a crisis, before reported inflation had fully retreated. Dollar weakness under this scenario could deliver a significant inflationary impulse to the economy and permanently alter bond investors' perception of the inflation outlook, especially if China's economic profile begins to lift off.
- The case for yield curve normalization driven by lower short-term interest rates hinges on downside risks to the economy. If in correcting its first mistake of being too easy the Fed creates another by being too restrictive, monetary deflation could lead to recession and a serious undershoot of its 2% target if not deflation at some point in the future.

The Fed sees both tail risks but expresses no conviction on which is fatter. The FOMC members' 2025 estimates for the federal funds rate contained in their latest economic projections range from over 5% to under 2.5%. While refreshing in candor and realism, it is unnerving. The Fed's current guidance system for policy is focused on the non-rent services part of the consumption basket—in other words, not just inflation itself but the stickiest part of the basket. Policy guidance is set up for an overshoot, given the long lags between Fed action and inflation reaction. Presumably the Fed blinks before that, but under what conditions?

What's Changed This Quarter?

In our minds, the balance of probabilities between these two tail risks tilted toward recession over the last few weeks of the first quarter, owing to escalating disintermediation in the U.S. commercial banking system. The contraction in M2 and deposits should mirror a substantial retreat in lending.

Commercial bank deposits dropped nearly $500 billion during the month of March alone, virtually matching the total decline in deposits during the preceding 12 months. There were over $10 trillion in uninsured deposits as of June 2022, according to the FDIC, indicating the potential for a lot more deposit outflows ahead. The Fed has indicated it will accept government securities at par from any bank needing liquidity to fund deposit withdrawals. The Fed's limitless capacity to create liquidity should in theory stem any systemic insolvency triggered by liquidity shortages. However, it does not prevent depositors from moving money out of the banking system. Banks' funding costs will rise, profitability will fall, and there should be a significant slowdown in bank lending. The recent contraction in lending could be a sign of more to come, particularly from regional banks. A major slowdown in nominal activity seems to be in the pipeline.

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