Audio Transcript: Not Your Normal Inflation
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Katie [00:00:04] Welcome, Francis Scotland. It's a pleasure to have you here with us today as part of Brandywine Global's podcasts, *Around the Curve*. I'm Katie Klingensmith with Brandywine Global and I'm pleased to host this conversation. For those of you who don't know Francis, he is the Director of Global Macro Research here at Brandywine Global, and he's held that important post since 2006, where he serves as a source of insight for all of the different portfolios that we manage at Brandywine Global. Well, today we're going to spend the bulk of our conversation focused on inflation, and it's no wonder because this topic has been on everyone's mind with inflation in the United States, at least at the highest level we've seen in 40 years and obviously a preoccupation around the world. Delighted to have Francis here to explore some of the implications of inflation and some policy responses to it. So let's dive in. Francis, just to get us started: where are we in the global economic cycle right now?

Francis [00:01:03] Hi Katie, thank you for being here. That's a good question about the cycle, but it's important to keep in mind, or at least keep in perspective, this is anything but a typical global economic cycle. This is the follow-through from a major disaster. So, you know, we need to keep that in mind when we ponder, where are we in the cycle? And typically, recessions are triggered by some kind of excess: inflation, tight money, a supply shock, like rising energy prices. But this time around, it was the lockdowns in 2020. So, it's more like a war economy where suddenly the factories are shut down. Employees are told to stay home. The collapse in the economy was apocalyptic. It was the biggest, fastest bust in economic history, and we rebounded out of that hole faster than any previous, more normal economic recovery as well. And the drivers of that rebound have been reopenings. We turn the lights back on. How people have pivoted to dealing with the crisis, like us working from home. And a whole lot of policy stimulus around the world. So where are we now? The U.S. is probably the only major economy in the world where real GDP has completely returned to its pre-pandemic potential trend. Nominal GDP is way above trend because of inflation. In Europe, real GDP is still well short of its potential trend, and elements of the Chinese economy recovered very quickly. But underlying consumer spending remains weak, which is really another aspect of where we are in the cycle right now. The U.S. rebound has been led by consumption—until recently, the consumption of durable goods. And it’s the only major economy in the world where nominal personal consumption has really eclipsed its pre-pandemic trend. China, on the other hand, has been lifted by production and exports—the world's factory. Domestic spending in the Chinese economy remains relatively weak. So, this has been a really major but very unbalanced rebound. Now it's behind us. All the leading economic indicators for all the major economic regions of the world are in retreat. Real economic growth has already started to slow back towards whatever the underlying potentials are in the various economic regions of the world. In the U.S., the pre-pandemic trend was not much different than two percent real GDP growth. Less in Europe. In China, probably five to five and a half percent is their underlying potential. China is probably the furthest advanced in the slowdown. And the issue now is how fast, coming out of 2021, on this big reopening, high-growth trajectory. How fast are we going to mean revert in growth? How fast will that mean reversion in growth take place? And what will it do? What will inflation do in the process? So no one is really talking about a slower economy right now, which is what's happening. And inflation should reverse as well, but for a period, maybe in the first quarter, it may feel like a whiff of stagflation. And the real question is: how far will economic growth retreat and how fast will inflation follow?

Katie [00:04:00] Thank you, Francis for those insights on the global economy. And you touched on inflation. That's obviously the focus right now. Can you just give us a bit more depth on where we're seeing prices up and what's driving them?

Francis [00:04:11] Sure. I agree. Inflation is the buzzword, particularly in the U.S., where it seems to be going up everywhere. CPI/ PCE inflation rates are at multi-decade highs. Wage inflation is back to levels we saw at 10 or 12 years ago. Commodity inflation last year was really, really, really strong. There's been a lot of debate on this topic on whether it's supply or demand-driven inflation, and maybe it'd be helpful to sort out the meaning of these two because it can help in thinking about the drivers going forward and what's causing the inflation. So, in a supply shock, prices go up because you can't get stuff. You think about semi-conductors, weakness in cars, car production, and used car prices. Inflation goes up, but growth slows, output weakens. And in a demand shock, prices go up because everybody wants the same thing. Inflation is up, but growth picks up, too, if there are no supply constraints. So, we've had both of these elements coming out of the pandemic. And let's focus on the personal consumption of durables. So, going into the pandemic, everything collapsed, including consumption. But by May of 2020, personal consumption of durable goods had rebounded back to the pre-pandemic level. In the nine months following May of 2020, spending in that category went up more than it had gone up the previous 10 years by over $600 billion, or almost $600 billion. So that's significant because the just-in-time inventories and global supply chains were all constructed based on predictable incremental expansion year after year, which is what we saw in the 10 years previous to the

pandemic, but certainly not the experience in 2020 and 2021. That fostered an enormous pickup in inflation. In addition to supply chain disruptions, we've experienced energy price shocks and labor shortages, all of which come under the category of supply shocks that restrict output and boost prices or inflation. On the other side of the inflation story, the demand side, particularly in the U.S., governments have worked to keep personal incomes from falling off throughout the crisis because of the supply shocks. And they've done that by introducing large fiscal outlays. The biggest in the United States since WWII. There's been nothing like it since then. Federal outlays went from almost four and a half trillion in 2019 to six and a half to 6.8 in 2020 and 2021. That increased the deficit by more than four trillion dollars or added four trillion dollars of public debt over the last two years relative to what would have been the case based on the deficit in 2009, with the Fed buying most of it. So as a result, the inflation rate in this category of durable goods consumption has gone from a level of averaging minus two percent for the past 20 years to nearly 10 percent at the end of 2021. It is by far the single largest contributor to the overall spike in price inflation we're seeing now. Energy and food prices are the other two major contributors. But it's spread as well to wages—employment costs have surged. Employment Cost Index is surging. Inflation expectations based on the University of Michigan survey are starting to move higher. So, this rebound in inflation is not just in the U.S. of course, it's global, but the degree of the rebound is in proportion to the amount of fiscal support primarily that was provided in other countries. European inflation is up as well, but not nearly as much as in the U.S., but neither was their fiscal support as extreme. And in China, the CPI inflation rate has already crested and may be rolling over. The Chinese authorities used the least amount of policy stimulus and were the first to tap the brakes as early as the fall of 2020 and begin reversing some of that stimulus.

Katie [00:07:54] So obviously, stimulus is a big part of the story, and I appreciate you walking through the supply and the demand explanations. The Fed seems to have really shifted their views on what they anticipate out of inflation. What do you think were the factors that pushed the Fed from considering inflation essentially transitory to now being very concerned that it might rise?

Francis [00:08:16] I would agree. You're right, it seems the Fed has done a complete U-turn on its forward guidance. All their actions are still way behind their words. They promised to accelerate tapering. They've openly talked about multiple rate hikes shrinking the balance sheet. In testimony before Congress at his confirmation hearings, Fed Chair Powell talked about the size of the Fed's balance sheet at nine trillion being truly excessive. I find the speed of the change in the Fed's rhetoric really quite shocking. It feels to me like they're in full panic and they're worried that they've let the inflation cat out of the bag. After wedging himself into a corner with what seemed like ironclad conviction that inflation was transitory, Chair Powell threw in the towel. He's acting like he's way behind the curve. I think it's just the sheer scale of the inflation numbers, the breadth of the inflation across assets, goods, and labor markets, and just the length of this upsurge that has had them folding. And I think pressure from the administration whose popularity is sinking in the polls, partly due to inflation. And I think, you know, comparisons of this outburst of inflation with the experience of the 1970s—a lot of people are talking about it. That's caught the attention of the Fed as well. The 70s were characterized also by some major supply shocks in the form of OPEC price hikes, as well as a big change in the monetary regime with the suspension of the dollar-gold exchange standard to a free float. And once inflation gets into the psyche of households and businesses, it gets really hard to reverse without a recession. So, I think those are all sort of an accumulation of factors, which I think has provoked this U-turn in Fed rhetoric.

Katie [00:10:04] It's definitely a big shift, and I do, in a few minutes, want to get back to what that might mean for investors. But just staying with the Fed, it now looks like markets are essentially anticipating four rate hikes this year. And if we do get that level of increase in the Fed funds rate and potentially the Fed even fully starting to reduce the balance sheet that they have. What do you think this would do to financial markets and what might it do to the U.S. real economy?

Francis [00:10:33] I agree, I think it's one of the most important questions for 2022, especially given them the market's current concern about a policy mistake. Historically, the Fed hasn't had much luck achieving soft landings, and what I call this U-turn in policy bordering on panic has raised a lot of concerns about overdoing it from investors as well as leaders of other countries, not the least of which comes from China. President Xi spoke at the Davos conference this week, warning that if major economies—speaking to the Fed—slam on the brakes or take a U-turn in their monetary policies, there could be serious spillovers for the developed world, including China. Obviously, the Fed's going to be really reactive to domestic developments, and arithmetically year-on-year inflation rates aren't going to peak much before March. But underlying inflation rates already appear to be retreating, which is a bit ironic considering the timing of the Fed's capitulation to thinking inflation is something other than transitory. So, with the economy slowing, as I said earlier, it's going to feel a bit like stagflation for a while. There's no reason to expect the Fed to be any more timely about the end of tightening move than it has been on reversing stimulus. I personally think the Fed is going to be limited to some extent in its ability to raise rates by the effect on risk assets, something we've been seeing.

There's already been a significant amount of damage inflicted in equity markets in anticipation of this shift. So, I think the weak link in the daisy chain between the Fed and the real economy are the financial markets, the possibility of a negative wealth effect. As for shrinking the Fed's balance sheet, I think this is a very big unknown, potentially the most important part of the Fed's U-turn. I'm a bit surprised that Fed Chair Powell seems as categoric about this initiative. It could be very deflationary if the money multiplier doesn't pick up. So as with global growth, I'm looking for inflation to retreat next year or this year, I mean. The issue is going to be how far? How fast? One thing you could keep an eye on is the CRB Commodity Price Index. Like many other assets, last year, commodities had a really big inflation, but they've stabilized. This is a pretty decent coincident indicator of global growth momentum, correlates well with inflation. It’s been flat since October, so a significant deceleration, I think, is already in the pipeline, which makes sense. Consumption in durables is probably saturated, and the best cure for high prices is high prices. So real incomes have been falling all year due to reduced fiscal support and rising inflation.

Katie [00:13:12] So given those trends, perhaps this gives us some insight about what's happening in bond markets. I mean, it seems that bond markets have basically ignored the spike of inflation. Are bond investors being blind to the risk of low real yields and spiking inflation currently, just like they were somewhat blind to the opportunity of high *real* yields and falling inflation in the mid-1980s.

Francis [00:13:37] It really is remarkable. With inflation near seven percent based on the CPI, and nominal GDP last year ending around 13 or 14 percent in the U.S., that the 30 year yield is only slightly above two percent. So, the bond market is clearly looking through a lot of this, and I can think of a few reasons why investors might be taking that viewpoint. First, you know, less than two years ago, the secular forces influencing bond yields were demographics, technological innovation, and competition from globalization. Those forces haven't gone away. And second, the bulk of the bond bull market for the last 30 years has been falling real yields. Inflation has been pretty stable until the pandemic. So, it's been a trajectory of falling real yields that has driven the bull market. And whatever has been going on in the past 30 years got a lot worse during the last couple of years. Surplus private savings relative to private spending was a popular theory for that bull market. And savings, we know that savings grew dramatically through the pandemic, although spending surged due mainly to fiscal support. And savings may have normalized more recently with the retreat in the savings rate, but global savings may be picking up again based on the increase in what we see in China's current account surplus and reactions in a lot of the emerging countries where policymakers have been tightening. And a third factor, which might explain why the bond market is looking through this is that sustainable inflations in the past have tended to coincide not only with supply shock like we're experiencing now, and OPEC one and OPEC two in the 1970s, but also protracted weakness in the U.S. dollar. And so far, we haven't seen that. It may come in the future, but a material deterioration in the market’s outlook for inflation really seems, I think, to be associated or requires a decline or a sustained decline in the U.S. dollar. In a zero-bound world, which we've been operating in for the last decade or so, most of the effects of monetary policy work through the exchange rate. And in a free flow, any unusual strength in the U.S. relative to the rest of the world, which has been the case now for 18 months, gets shed into the rest of the world by a strong and stable dollar. So, as I pointed out at the beginning of our conversation, most of the rest of the world is still operating below potential, with the LEIs (leading economic indicators) pointing down as in slower growth. So transitory is a relative term, but the bond market seems a lot more patient about the Fed. Or, it may be that the bond market has been counting on the Fed to do exactly what it's doing now.

Katie [00:16:24] Thanks, and that was a lot of different material. I wonder, Francis, if you could just spend a couple of minutes to wrap us up. And just walk through quickly: what are the primary factors that you're watching now in terms of growth and inflation and the Fed? And then ultimately what that means for bond investors?

Francis [00:16:42] Sure. Well, because of base effects, year-on-year inflation rates probably aren't going to peak before March, but they should retreat thereafter. And in the interim, probably looking for the U.S. economy to slow, albeit from a pretty high level, but keep in mind, the potential GDP growth pre-pandemic was not much more than two percent. No one's really talking about the possibility of a decent retreat in growth, but it seems the most likely scenario to me. Which may conjure up a whiff of stagflation at the beginning of the year, at least for a while before we head into the second part of the year where we should expect inflation to retreat further. In terms of the Fed, having gone U-turn on guidance, the question now is are they going to deliver? A lot has been priced in. What exactly are they going to do? What exactly are they going to do when they're done tapering? As the year progresses, will they deviate in any way from the hawkish trajectory that they've laid out? And most importantly, what kind of guidance are they going to give on plans to shrink the balance sheet? That could be more potent than any decision to raise interest rates. So as far as global bond markets go, stability in the dollar is probably the single most important thing to watch here. Dollar stability is a big part of the bond market, believing that the current inflation is not sustainable.

And now, with China taking measures to boost its domestic growth profile, how is that going to play to the dollar's outlook? Those would be the major things to focus on.

Katie [00:18:13] Thank you. And really, first and foremost, thank you to our clients and audience for participating in this conversation between myself and Francis Scotland, who's the Director of Global Macro Research here at Brandywine Global. Thank you, Francis. Thank you all.

Francis [00:18:27] Have a great day.