Macroeconomic Update

Brandywine GLOBAL

Normalization: Unwinding the Excesses

Francis A. Scotland
Director of Global
Macro Research

It has been an ugly start to the year from an investor's viewpoint:

- Cryptocurrency markets crushed—Bitcoin and Ethereum down roughly 80%
- Equity indexes in the U.S. and Europe down 20% or more
- The NYSE FANG+ Index down over 40% from its 2021 high-water mark
- Commodity prices tumble—lumber off over 60% at one point this year
- The U.S. 10-year Treasury note's first-half performance was the worst of any year since 1788, according to Deutsche Bank Research
- Corporate credit weighed down by the selloff in duration with spreads widening in June on recession worries.

Portfolio diversification offered no defense for long-only investors. Even cash returns were eaten away by inflation. Estimates vary, but U.S. household net worth may have contracted as much as $10 to $15 trillion in the first half of the year.

The story behind these developments is normalization.

The global economy is trying to regain its pre-pandemic footings but has been forced to adjust to last year's excessive government support measures. These interventions rocketed major regions of the world economy out of the economic disaster created by the pandemic lockdowns in 2020 and left the U.S. well above pre-pandemic trends in nominal gross domestic product (GDP)—but not in real terms. The world economy cannot grow much faster than a few percentage points without inflation in normal times. Last year's combination of extraordinary stimulus measures and crippling supply-side developments, which was anything but normal, produced the highest inflation rates in decades. Unfortunately, much of the spending firepower handed to households by governments during the past two years is being sucked up in a spiral of rising prices. History offers no precedents for these developments, no matter how many analysts try to equate it to a stage in the economic cycle or compare it to other periods in economic or financial history.

If that were not enough, the war in Ukraine and Western sanctions have escalated into the weaponization of energy by Russia. A similar escalation preceded the war between the U.S. and Japan over 80 years ago. President Roosevelt worked to bring commercial relations between Japan and the U.S. to an end in 1940, ultimately embargoing all oil exports to Japan. Now it is Russia demanding payment in rubles from any unfriendly country, presumably including every member of NATO, while selling oil at a discount to all its friends.

The good news is that the destruction of wealth during the first half of the year suggests that the process of normalization is likely in the well-advanced stages of readjusting back from the inflationary overshoots that developed last year. The current phase is painful and could linger longer, but it is encouraging in terms of boosting the probability of a more sustainable macroeconomic trajectory. The risk is that policymakers and politicians keep blundering in a way that defers this outcome and increases volatility in the interim.

Whiplash: Booms Follow Busts which...

At the start of the year, we discussed the likelihood that mean reversions in the more anomalous trends of 2021 would be the main drivers of the macro road map for 2022. A full and complete reversal of those trends—something we considered a possibility—would be tantamount to a case of economic "whiplash." Of all the macro trends in 2021, the most anomalous were:

- Extraordinarily rapid growth in the U.S.
- Hyper-expansionary policy tailwinds
- The highest inflation rates in 40 years, at least in North America and Europe.

At the mid-point of 2022, it is clear that all these trends are in various stages of reversing. The only question is: How far?

The World Economy Is Slowing Rapidly

Most leading indicators point to recession, a prospect emphasized by the recent break in the price of copper. We flagged the potential for a sharp slowdown earlier this year, based on collapsing real money growth, the lagged influence of rising bond yields, repressive increases in the price of energy, and the cumulative effect of policy tightening around the globe. Looking across the world, the outlook for growth looks dim:

- China has been in a man-made recession all year due to its zero-COVID tolerance. The authorities have become more focused on rekindling economic growth, the latest stabilization initiatives drawn from the infrastructure-spending playbook. What is different is that the spending is to be financed by drawing down $200 billion of next year's bond allocations from local government budgets. Land sales are no longer a source of funding for these governments because of recent measures to reduce property speculation and the effect on prices. It is hard to see how potent these measures can be in the face of the country's dogged zero-COVID policy, especially given the infectious nature of the latest virus mutations.
- Europe has tripped into contraction due to massive increases in energy prices, a situation that is now exacerbated by the prospect of energy rationing after Russia gave notice of its intent to reduce gas supplies. The risk is that the contraction could be very deep.
- And in the U.S.—likely the hottest economy on the planet—the second quarter should print another negative growth headline, the second in a row. This is an extraordinary retreat from last year's torrid expansion and in keeping with the theme of whiplash. Real disposable income has been falling since March of last year despite strong job gains, a consequence of dwindling fiscal support and surging price inflation. Adjusted for inflation, there has been zero growth in personal consumption since October, new orders for non-defense durable capital goods have been falling all year, and housing activity and prices are beginning to slow. It is difficult to conceive of recession with employment still expanding briskly. However, corporations' margins are beginning to succumb to persistent cost increases and decreasing ability to pass on higher prices to consumers. Cost cutting will follow the longer this environment continues.

Policy: From Panic Expansion to Panic Contraction

Last year's anomalous state of the Federal Reserve (Fed) continuing to ease into a boom has reversed with a vengeance, another clear illustration of macro whiplash. The Fed wants to hit the brakes, a 180-degree reversal from the recent two-year effort to stimulate the U.S. economy. This U-turn in guidance smacks of panic, which is a normal human reaction when you think you got something wrong that is very important. The Fed is reversing course from last year as fast as possible to compensate for its wrong read on inflation and crumbling credibility. Politicians who cheered the Fed's "woke" focus on employment last year now want the central bank to do something about the inflation havoc wreaked on real incomes from this strategy.

Other developed country central banks are following suit. The European Central Bank—whose only remit is inflation—is gearing up to reverse course even with the economy sinking. This endeavor may not go very far given the arrival of a new “anti-fragmentation instrument” to contain peripheral spreads.

The central bank teams that got inflation wrong last year now say they are going to fix the problem, just as economic growth heads south. Will they fix the problem or create a new one? From inflationary overshoot to recessionary payback?

In China, the problem is the opposite. The authorities are moving to stimulate the economy, but these measures are dulled by the zero-COVID tolerance. Policymakers seem to realize this conundrum, so while they are resisting full-scale stimulus, they keep adding it incrementally.

Inflation: The Biggest Anomaly of Them All

Inflationary impulses have peaked. In all likelihood, so has inflation. Global leading indicators show the early stages of a shift to rising inventories and softer demand from booming demand and backlogs, paving the way for easing price pressures.

The 10-year U.S. breakeven inflation rate is at its lowest level in a year. Meanwhile, the 5-year forward inflation rate has dropped 50 basis points but could revert another 100 basis points lower based on its relationship with the dollar. In Europe, month-on-month producer price inflation dropped sharply in April and May compared to the previous nine months. China’s year-on-year wholesale price inflation has fallen nearly in half from a high of 10% last October.

Importantly, the Commodity Research Bureau (CRB) Raw Industrials Index has started to mean-revert lower. Past correlations with headline U.S. Consumer Price Index (CPI) inflation suggest that the latter could fall from current levels of 8% to roughly 2%, further if the CRB keeps falling. Similarly, the correlation between the CRB and world trade prices implies an equally dramatic decline in trade inflation.

News headlines invariably focus on the previous day’s story, which has been inflation and more recently stagflation. The slippage in the global economy coupled with pro-cyclical monetary policy suggest that the new risk narrative soon could become much lower inflation.

The real question is whether this mean reversion will play out in terms of falling price levels and not just lower inflation rates, the latter referring to a slowdown in the pace that prices go up. Hotel, restaurant meal, and air travel prices are all dramatically higher than pre-pandemic levels, partially a response to pent-up demand but also an effort by businesses to recoup losses incurred during the lockdowns. While these increases may slow, it remains to be seen whether price levels start to recede. Deflation would follow any tendency for prices to mean-revert downward, even if prices settle only partially lower relative to pre-pandemic trends.

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Brandywine Global Investment Management, LLC

1735 Market Street
Suite 1800
Philadelphia, PA 19103

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