Video Transcript: Global Macro Webcast – 3Q 2021

Francis Scotland

Brandywine Global Investment Management

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The key variable in the macro outlook continues to be the pandemic. Retreating numbers of confirmed global virus cases, the ramp-up of vaccinations around the world, and Merck's announcement is really good news for a world economy still not fully reopened. The known unknown is the potential for new mutations. But these developments offer relief and a roadmap of hope that the marginal impact of any new wave will decline as we learn to live with the virus and new therapeutics overcome this disease.

What does this mean for the economic outlook and getting back to normal? Are we going back to normal? What will normal look like? What will it imply for asset prices, many of which are stretched, none more so relative to history than high commodity prices and low real bond yields?

One sign of renormalization is American football stadiums; they are filling up. But for Treasury yields, renormalization has been a two-step-forward, one-step-backward shuffle up to now. The upward trend has been relatively meek so far, yields still below March levels. Chinese 10-year bond yields have retreated to levels that existed in February 2020, following policy renormalization in August of last year. For discretionary investors there is not much incentive to own developed country fixed-income, yet yields remain remarkably low—negative in Germany—and the dollar is stable. Central bank bond purchases? Or something else?

A lot has changed from before the pandemic to today, but the one most are focused on is inflation. Is it temporary or is it permanent? The Federal Reserve (Fed) and European Central Bank (ECB) are making a big bet that current inflation is mainly due to supply side distortions. Once those supply factors improve, prices will stop going up and inflation will retreat. The risk is that they are not temporary, central banks fall behind the curve, and inflation becomes more systemic. We think the Fed is making the right bet, but it could take longer to play out than the Fed wants.

So far, the markets believe it (or, perhaps less conviction in the Fed than in productivity keeping pace.) Forward breakeven inflation rates and the dollar remain stable. It is hard to see a meaningful deterioration in the inflation outlook without a breakdown in the dollar. Instead, the narrowly defined trade-weighted dollar was a mere 3% lower at the end of the third quarter than it was on December 19, 2019, despite trillions in balance sheet expansion, trillions in new government debt, exploding budget deficits, an increase in the current account deficit, the election of a left-of-center administration, and rising headline inflation. This speaks to an underlying demand for dollar liquidity that comes from within the U.S. economy, not from outside. This may not always be the case, but dollar demand has been growing, not shrinking, since the start of the year.

The main question is what's causing inflation?

- Reopenings are happening faster than supply is coming back on stream. The economic bust hurt both demand and supply, but supply has been more difficult to recover than spending, the latter aided by massive fiscal spending programs. **(CHART)** Core PCE is 3.6% higher than a year ago, the highest level in the U.S. in 30 years. Much of this was concentrated in durable goods inflation early in the pandemic, but it is beginning to spread across the consumption basket, including rents. The longer supply conditions take to recover, labor shortages may turn out to be another supply shock.
- Demand for oil and natural gas is rebounding faster than the ability to meet this demand without higher prices—it could be that decarbonization goals are too ambitious relative to the ability of alternative energy to fill any gaps in demand. Energy price spikes always have consequences.

It is up to monetary policy to put on the brakes if supply shocks reduce the non-inflationary growth potential of an economy—which it usually does. U.S monetary policy historically has leaned into any rise in headline inflation caused by an increase in energy prices, a development that has often preceded recession.

Not this time.

Policy has stayed expansionary, owing to mission creep at the Fed and ECB and new inflation targeting regimes. But the main reason is that Western central banks think the spike in inflation is temporary. From Fed Chair Powell's perspective, squeezing the economy now would be like closing the doors on the hospitals to prevent the pandemic from overrunning the healthcare system when what you really need is more hospital beds. The world needs distribution and supply to get up the curve.

It's a big bet if it is wrong because the only tool it has to correct inflation is a monetary crunch, which includes recession.

One factor mitigating some of this inflation risk comes from China. To all intents and purposes, the ebb and flow of the world economy has been led by this economy and fluctuations in the impulse of credit growth. The latter has bottomed, but there is no sign yet of a generalized reflation of the Chinese economy. China's policymakers want to deleverage the economy and have adopted a "cross-cyclical" policy framework, which seeks to dampen down the size of what would be more normal counter-cyclical moves.

Evergrande may turn out to be a successful controlled implosion of the largest property company in the country, but it is a deflationary shock as China tries to pivot away from the property sector as the mainstay of its financial system. Property speculation, excess-inventory, and a demographic cloud hang over this sector. The government won't let it deflate but would like to redirect savings away from this sector to other industrial activities.

The world is slowing going into the end of the year led by China, those emerging economies that have been raising interest rates, fiscal retreat across the developed world, and by the depressing influence on real incomes and spending caused by rising inflation. Vaccinations and therapeutics, on the other hand, continue to improve prospects for the world to completely reopen, which would lift economic activity and alleviate some of these supply factors. Central

banks are making a big bet that supply conditions will improve enough to lower inflation in the future.