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Lower Inflation but More Stress Events

As usual, a lot is going on in the world that is relevant to the macro profile affecting capital markets, but we think the thing that still matters most is inflation.

It has fallen a lot in the U.S., and optimism that it is going to keep falling is what has supported risk assets. We think it is going to keep falling as well and could fall very sharply over the next six to 12 months. But the Federal Reserve (Fed) is not convinced and remains wedded to the idea that policy rates and the unemployment rate need to go higher and demand pressures need to soften in order to push inflation back to target. How do we think this might all play out? Do we need a recession to crush inflation? Will we get one anyway if we don't?

For two years we have been stressing in these podcasts that looking at post-pandemic developments through the lens of conventional business cycle analysis would be misleading. Instead, our perspective has been to think of the economy as trying to normalize or stabilize itself from some kind of natural disaster, which in this case has been consecutive waves of unprecedented policy shocks:

- First came the government-mandated lockdowns and the bust
- Then came the re-openings and mega-policy stimulus
- And lastly came the 180-degree reversal in monetary policy

Looking at the economy from this perspective of normalization suggested that there was a reasonable chance of avoiding a recession amidst all the churn in excess savings, liquidity, expanding income growth as employment normalized, and the policy flip flops—if inflation fell fast and low enough for U.S. monetary policy to pull back.

Our base case has been a shallow recession and/or below-trend growth. We expected the profile would turn out to be more a case of sector-by-sector adjustment from the post-pandemic churn with some industries retreating and others expanding. And so far, that is what has been playing out. Falling energy prices and improved supply chains are disinflationary and positive for growth, which offset some of the negatives (see Chart 1).

Personal income and spending growth offer the best perspective on the enormous distortions; after three years, these two measures have realigned but with a very low savings rate (see Chart 2). A lot of recession forecasts are predicated on a return of the savings rate to pre-pandemic levels, but maybe a lower savings rate will become a more permanent feature with a significant number of boomers leaving the labor force the past few years and now living off reduced incomes and assets.

But it all comes back to the inflation call. We have reasons to be more upbeat about it than the Fed:

- First, the financial and monetary variables all point in this direction: the second most inverted yield curve in history, the collapse in money and credit growth, and the disintermediation in the banking system.
- Second, inflation is the final piece in a falling line of dominoes. What went up in 2020 and 2021—cryptocurrency, commodities, real estate, money and credit, economic growth, and inflation—have retreated in perfect sequence starting late 2021 and early 2022. Now it is inflation's turn, and the trend to disinflation shows that it has clearly started. June's Consumer Price Index (CPI) is completely in line with this evolution (see Chart 3). Excluding food, energy, and shelter had no inflation in June, and we know that market measures of rent are all declining, which implies owners' equivalent rent, part of CPI, should retreat in next six to 12 months.
- Third, we all understand that policy lags are long and variable. But inflation peaked in June of last year, which means most of the disinflation we've seen since then has had little to do with Fed policy. In all probability, most of it is related to supply side improvements, which according to a variety of metrics have improved significantly (see Chart 4). This means that what the Fed has done has yet to influence the inflation measure. So, it is logical to think that disinflation should continue and probably intensify over the next six to 18 months, and we'd not be surprised if we get a whiff of deflation.
- Fourth, the world's factory is exporting its deflation. Domestic spending in that economy is extremely weak. China's PPI is negative, and core CPI is virtually zero (see Chart 5). U.S. import inflation is negative as a consequence, a development that gives the opposite of stagflation—a falling price expansion. A lot of people anticipate some major policy initiatives in China to get things going again. But China's options are constrained to some extent. They already have a very large budget deficit when all levels of government are factored in and its determined not to reflate the property sector.
- Fifth and finally, in the other major economic zone in the world—Europe, the monetary profile looks extremely deflationary even though reported inflation is still high (see Chart 6). The real economy never made it back to its pre-pandemic trend (see Chart 7). It is already in technical recession, and, like the U.S., it is importing deflation. But the European Central Bank remains extremely hawkish because the reported inflation data has only just started to retreat. In a sign of what may lie ahead for the rest of the region, Spanish headline CPI came in at 1.9% for the year in June.

So far, the Fed is not buying it—expectations are that it will raise rates again in July. The evidence the Fed talks about seems mainly the inflation rate itself and the labor market. The central bank really seems wedded to the idea that reducing inflation requires a looser labor market, and it is fighting with fiscal policy, which is pushing in the wrong direction—government spending is running over a trillion above pre-pandemic trends and rising. This policy stance is a recipe for an overshoot and financial/economic stress. We've already had a couple signs of financial stress caused by the policy trends: last year's event in the U.K. pension industry and this year's banking failures. Nonetheless, the Fed is growing confident that it can manage financial system stress and fight inflation at the same time. While the good news is that inflation should keep falling, the prospect for more stress events keeps rising as long as the Fed stays on its current trajectory.