Video Transcript: Global Macro Webcast – 2Q 2022

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July 13, 2022

Normalization: Unwinding the Excesses

The first half of the year could not have been much uglier from an investor's viewpoint: Cryptocurrency markets like Bitcoin and Ethereum were off 80%. We had equity bear markets in the U.S. and Europe with indexes off 20% or more; the NYSE FANG+ Index was down over 40% from its 2021 high-water mark. Commodity prices retreated, lumber was down almost 65% at one point in the first half of the year. The global fixed-income trend setter—the U.S. 10-year Treasury note—had the worst start of any year in decades, and credit was smashed by the selloff in duration, with spreads opening up in June on recession worries. Portfolio diversification provided no defense, not even cash where inflation ravaged real returns. 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 macro story behind these developments is normalization. The global economy is still trying to find its pre-pandemic footing but was forced to adjust to last year's excessive government support measures that rocketed major regions of the world economy out of the economic disaster that was created by the lockdowns in 2020. The world economy can't grow much faster than a few percentage points without inflation in normal times. The combination of last year's extraordinary stimulus measures, particularly in the U.S., and supply side constraints around the world produced the highest inflation rates in decades. See **Chart 1**. In other words, 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—supply-side issues crimping the world's non-inflationary growth potential—with economic policy pushing the squeeze even harder. If that were not enough, war in the Ukraine and western sanctions has escalated into the weaponization of energy by Russia.

There are no historical precedents for this combination of factors, no matter how many analysts try to stage the economic cycle or compare to other periods in economic/financial history. This is a highly unsynchronized world economy trying to find a post-pandemic equilibrium point following the economic disaster of 2020 and some of the policy blunders that have taken place

since. If there is any good news in this, it is that the scale of the contraction in household net worth suggests that this normalization process may be well advanced.

At the beginning of this year, we suggested that mean reversion in some of the more anomalous trends of 2021 might be the main drivers of the macro road map for this year. We thought that a full and complete reversal of those trends—something we considered was possible—would be tantamount to a case of “whiplash.” And in our webcast three months ago, we modified the notion of a whiplash to economic hangover. This roadmap still looks like a reasonable route to consider as the macro background for the remainder of the year and into 2023.

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 the mid-point of the year, it is clear that all these trends are in various stages of reversing. The only question is how far and how fast?

On the growth front the world is slowing very quickly. Most leading indicators point to recession, a prospect emphasized by the recent sharp break in the price of copper. We flagged this prospect earlier this year based on collapsing real money growth, the lagged influence of rising bond yields (see **Chart 2**), the repressive cost of energy, and the cumulative effect of policy tightening around the globe.

China has been in a man-made recession all year due to its zero-COVID tolerance. Europe may have already tripped into a contraction, and it could end up being a deep one due to massive increases in energy prices—and now the prospect of outright energy rationing with Russia. And in the U.S—the hottest economy on the planet—the second quarter gross domestic product will come in negative two quarters in a row. That’s a pretty dramatic reversal from last year’s record growth and very much in line with the theme of whiplash. Real disposable income (see **Chart 3**) 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, a lot of economic metrics are weakening very quickly. It is hard to call it a recession with employment still expanding pretty strongly, but we think that we have arrived at the point where companies can’t keep passing on

price increases to consumers. Yet costs keep rising, all of which implies that margin pressure is starting to build, which will lead to cost cutting.

On the policy front, the anomalous condition of the Federal Reserve (Fed) easing into a boom has also reversed with a vengeance. Policy has swung from a panic expansion to a panic contraction. Maybe an extreme case of 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. A pretty normal human reaction when you think you got something important very wrong. The Fed is reversing course from last year as fast as possible to compensate for its wrong read on inflation and crumbling credibility.

Other developed country central banks are following suit. The European Central Bank—who's only remit is inflation—is gearing up to reverse course even with the economy sinking, although this 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 turns south. Will they fix the problem or create a new one? From inflationary overshoot to recessionary payback? And what about 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 from booming demand and backlogs to rising inventories and softer demand, paving the way for easing price pressures. The 10-year U.S. breakeven inflation is at its lowest level in a year while the five-year forward inflation rate has dropped 50 basis points but could go a lot further 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 CRB Raw Industrials Index has started to mean-revert lower. Past correlations with headline U.S. consumer price index suggest that the latter could fall from current levels of 8% to much lower levels, further if the CRB keeps falling. See **Chart 4**.

News headlines invariably focus on the previous day's story, which has been inflation, but the slippage in the global economy coupled with pro-cyclic monetary policy suggests that the new risk narrative sometime late this year or early 2023 could become much lower inflation.