Video Transcript: Global Macro Webcast – 4Q 2022

Francis Scotland

Brandywine Global Investment Management

January 13, 2023

Welcome to 2023—and not soon enough. Last year's macro trends were dominated by rising inflation, rising yields, and tightening policy. The net effect was pretty ugly for most investors.

In thinking about the macro road map for this new year, the bad news is that last year's slew of known unknowns remain unresolved: Will the Ukraine/Russia conflict go nuclear? Will the U.S./ China dispute over Taiwan escalate? Where will the drive to net-zero take energy prices? What's next for COVID-19? Will China's U-turn on policy be enough to stabilize the economy? Will the Federal Reserve (Fed) overreact? Handicapping these unknowns is difficult.

What we do know is that a very unbalanced world economy entered the new year close to or in recession. China, the focal point of this weakness, was/is very deflationary. **CHART 1 Chinese PMI**. The Chinese Communist Party (CCP) has finally reacted to this weakness by bringing in the new year with a dramatic U-turn in policy—an abrupt and chaotic end to its zero-COVID strategy and a blitz of growth enhancing measures. In contrast, the U.S. entered the new year with the Fed's feet hard on the brakes and a lot of tough talk that the fight against inflation will be bloody enough to cause recession. The world's two largest economies seem set up for exactly opposite economic cycles this year.

Out of all this, I want to focus on three macro thematics, and much of it boils down to policymaker credibility:

1. First is waiting for the Fed to capitulate. Again.

The Fed has a credibility issue. It is obvious that the central bank made a big mistake in 2021, underestimating the momentum behind inflation and realizing it in March last year with its panicky U-turn. Since it flipped, it has presided over the fastest run-up in policy rates over any comparable period in history while simultaneously shrinking the balance sheet. The dollar soared as it tightened into a global downturn. Research at the San Francisco Fed calculates a shadow federal funds rate that takes account of the balance sheet and financial conditions. This measure has risen almost 700 basis points from its low in last March. **(Chart 2—Federal Funds and SF Shadow Federal Funds Rate)**

What's happened since this major Fed pivot last March?

In a word, deflation.

Like watching a movie backward, everything that went up during the boom phase of the pandemic has been coming down and in sequence: cross-the-board asset price deflation; industrial and energy commodities in retreat; real estate prices have started to fall; and not only

inflation rates but price levels are declining in a range of goods. The broad economy has remained supported by consumption, which has been propped up by a drawdown of cumulated savings and the savings rate. But deceleration is evident almost everywhere in both real and nominal terms. Broad price inflation measures have been rolling over: Headline CPI, which peaked at 9% mid-year, has risen 2.4% over the last 5 months of data (annualized), survey data suggest lower inflation rates ahead **(Chart 3—CPI and Supplier Deliveries Chart),** and wage and income trends in the December '22 employment report flag a sharp slowdown in nominal income growth.

In the meantime, Fed stringency has reached a level not seen in decades: Real money supply growth is lower than any time since 1980, while nominal money supply growth is contracting for the first time in 60 years **(Chart 4—nominal M2 growth year on year**), and commercial banks willingness to lend is in retreat.

Despite all these developments, the Federal Open Market Committee is ignoring the signs of retreating inflation as much as it was ignoring signs of escalating inflation a year ago.

This intransigence definitely increases the probability of recession, with the majority of economic forecasters suggesting one is already in the pipeline. But if inflation falls as quickly as some current trends suggest to us will happen, it is hard to believe that the Fed won't react to these developments earlier. And with oil prices down about 40% from their peak, a lot of "stagflationary" forces have reversed. Putting it all together, a timely response by the Fed to easing inflation could produce a soft landing and a shallow recession. Intransigence increases recession risks implying it will take something or some event for the Fed to capitulate.

2. A second thematic is the credibility of the CCP.

It should be obvious that the suite of policies promoted by the CCP and championed by President Xi have been a big mistake with the credibility of the party and the president taking a big hit. The reversals underway won't be temporary, notwithstanding the vulnerability of policy becoming subject to the whims of its strongman leader. Extreme economic weakness, property sector deflation, and the population's fatigue with the non-sensical COVID-19 policy erupted into rare criticism and protests that are an existential threat to the survival of the current regime.

The CCP has thrown the towel in on the zero-COVID policy, led by President Xi himself, and now seems determined to get it over with as fast as possible. President Xi has also taken the property sector off his hit list and put it on the help list amid reports that the authorities are preparing to relax restrictions on developer borrowings and dialing back on the "three red lines" policy. In addition, government officials are talking up business and the private sector after going in the other direction during much of President Xi's rule. China has even placed orders for Australian coal, suggesting that even its foreign policy might be shifting. All these developments suggest China is pulling out all the stops to stimulate economic growth.

Observing all these developments, our bias is to believe that the authorities will be successful in encouraging a rebound in the economy. Plus, the Chinese household sector is sitting on a tinderbox of cumulated savings, which would provide added spending firepower—that is, if confidence returns to the population, which is not a given. A second COVID-19 wave for China is expected in May/June, which may stall any rebound in confidence. In addition, the reversals in

policy direction, both on COVID-19 and economic strategy, from those championed by the president himself, suggest there must have been a lot of behind-the-scenes turbulence in the upper echelons of the CCP, which might not yet be over.

3. And a final thematic: The world's two largest economies appear to be on completely opposite cycles. One making a big U-turn toward stimulus and gunning for growth; the other very restrictive and prepared to take on a recession in the interests of reducing inflation.

Sequencing will be important for capital markets. Most leading indicators predict a softening in U.S. economic trends well into the year, based on what the Fed has already done, and further if the Fed continues to tighten. If inflation falls as fast as we suspect and the Fed pauses, the growth slowdown would be more shallow but still slower for most of the year.

In China, signs indicate that the pandemic may have already peaked across a range of big cities. How people react is not known, and another wave is expected in May/June. After years of indoctrination about the hazards of this virus, it may take a while to regain confidence. The measures to stimulate the economy are only beginning, the scale of support required to turn property sector around will have to be substantial. Markets may front run these trends but actual traction in the real economy may not develop much momentum before the second half of the year.

Netting it out, the first half of the year looks like it will be fairly disinflationary for the global economy with spending and growth looking quite weak.