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Well, it does not get any less complicated; everyone is struggling to figure out what is ahead: soft landing, hard landing, stubborn inflation, or deflation. But we believe that we have reached a turning point.

We keep looking at the investment and economic outlook through the lens of renormalization. The economy was hit by a pandemic-related economic disaster three years ago and has had to absorb massive and historic gyrations in economic policy in the three years since.

The contraction caused by the pandemic and lockdowns was not your normal recession, and the policy measures that have followed this disaster have been anything but conventional. It is not surprising that the recovery/renormalization process has also been unusual. Growth has bounced back from goods to services, and overall consumption has been supported throughout by excessive savings stockpiled during the crisis, which is now winding down. Parts of the U.S. economy are already in recession, like housing and manufacturing, while other sectors are doing well, such as rising auto sales and disposable incomes.

(CHART) Supply chains have seemingly healed, and inflation has peaked but remains higher than in 2019. Employment in the prime age work force has normalized, but job openings are still high. Wage inflation is elevated but in decline. Adding to the complexity, different countries have approached the disaster differently: China staying on lockdown until recently and Europe having to cope with an energy shock in the middle of everything.

Our macro focus is on the effort to lower inflation. How do you handicap the outcome of policy efforts to reverse an inflationary bubble caused by one of the worst fiscal and monetary policy errors in history? The same people who made the first mistake are leading the charge to make things right but at what cost and will efforts to unwind the first mistake lead to a second? Backtesting in this environment is not an option. Historical overlays could be more misleading than helpful. What should you focus on?

What we can say is that monetary cycles rhyme. Tightening episodes end when something breaks; a crisis is followed by a reflexive withdrawal of credit and often recession. Every tightening episode is different, but any crisis that comes of it does not end until there is at least a pause in tightening, if not a full retreat.

We all know that monetary lags are long and variable, but we think we have reached an inflection point where things are definitely breaking. Last year it was the crypto markets and multiple compression across asset markets. This year we are seeing stress events in the banking system. We don’t know if these stress events will escalate into a full-blown crisis, but what is clear, and driving our positioning at Brandywine Global, is the breadth and scale of the monetary deflation unfolding around the world.

In the U.S., the yield curve inverted long ago, signaling that Federal Reserve (Fed) efforts to correct its monetary mistake had gone too far. Nominal money supply is falling, real private credit growth has been contracting since June last year (CHART), and banks willingness to lend has been retreating. Commercial bank lending contracted over $100 billion at the end of March—banking stress events and the acceleration in deposit outflows from the banking system imply chronically weak lending ahead, especially for regional banks that have been the big drivers of loan growth during the pandemic. Broad measures of inflation are rolling over, yet the Fed is focused on lagging indicators and the stickiest segment of the household consumption basket, which guarantees an overshoot as long as it sticks to this reaction function.

The monetary story in Europe is just as bad. Narrow money balances are contracting, nominal credit levels have stagnated (CHART), and Europe's credit impulse has retreated to a level on par with the sovereign debt crisis.

China certainly isn't trying to tighten policy. There is no inflation there—producer prices are falling, and the Consumer Price Index is less than a percent. Yes, bank lending and total social finance are expanding, but interest rates are still 80 bps higher from their low last year (CHART), and narrow money growth has been almost flat since June.

What is the end point of all this monetary deflation? How does this normalization story play out? It seems intuitive that at some point all this monetary deflation translates into price disinflation or even deflation. But how and when we get there is not so obvious.

Our base case up to now has been a "muddle through" scenario where we believed that inflation would break before the economy did, which would give central banks enough time to take their foot off the brakes. The case for that scenario was the combination of monetary deflation, excess savings in households, and cash in companies. There are even a few hints of wage flexibility in the labor market. Our expectation has been that normalization would result in adjustments rolling through different parts of the economy at different times, which seems to be happening at the moment. The muddle through scenario could end up being reported as a shallow recession or below-trend growth by the end of the year, but it really hinged on inflation breaking before the economy and the Fed not squeezing too hard in the interim.

The muddle through scenario really lies dead center between the two tail risks in the outlook: one being a permanent ratcheting higher in inflation expectations, which has been the predominant worry up until recently; the other tail risk being recession, driven by a Fed that believes inflation can only be lowered if unemployment goes higher.

What changed during the first quarter? Monetary deflation seems to have reached an inflection point and the balance of probabilities between the two tail risks has tilted more toward recession. In our minds the new development is the escalating disintermediation playing out in the U.S. commercial banking system. Commercial bank deposits dropped nearly half a trillion dollars during the month of March alone (CHART), virtually matching the deposit outflow the previous 12 months. The contraction in M2 and deposits should mirror a substantial retreat in lending and could be a significant drag on the economy. This was partially confirmed by the March NFIB survey, which reported a big contraction in the availability of credit to small business. (CHART) And as I noted earlier, bank loans contracted over $100 billion at the end of March, perhaps the beginning of more to come.

The Fed has set up a facility where it will accept government securities at par from any bank needing liquidity to fund deposit withdrawals. And the Fed has limitless capacity to create liquidity, so this should, in theory, stem any insolvency triggered by deposit outflows. But it probably won't stop depositors from moving their money in search of better yield. The FDIC reported that there were $10 trillion in uninsured deposits in the banking system as of last June. Banks funding costs will rise, profitability should fall, and there should be a prolonged slowdown in bank lending, possibly a contraction in nominal lending, particularly from regional banks.

So net-net, all of this monetary deflation is pointing to a major slowdown in nominal economic activity ahead.