Video Transcript: Global Macro Webcast – 3Q 2022

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October 11, 2022

The worst global bond bear market in a century found no relief during the third quarter. Things just got uglier. Treasury yields have gone parabolic from their base in 2020 (see **chart 1**). And with much of the world economy teetering toward or already in recession (see **chart 2**), it is important to understand what is behind the inflationary mess driving the fixed income bust and the implications for what lies ahead.

We still think inflation remains closely linked to the pandemic and the historic but mistaken stimulus provided by public policy.

The 2020-2021 boom in the U.S. witnessed a surge in nominal gross domestic product (GDP) not seen in decades. *Real* GDP had a V-shaped recovery, coming out of the hole created by the lockdowns, but has returned to its pre-pandemic trajectory of roughly 2%; *nominal* GDP, however, kept exploding higher (see **chart 3**). So, most of the policy stimulus bled into higher prices. The bulk of the inflation shock has been more a case of too much money and spending than too little supply. Bond yields, which plumbed historic lows in the depths of the post-pandemic bust in 2020, have risen ever since and accelerated higher this year.

Recapping the sequence of events that have brought us to where we are today:

- It started with historic fiscal expansion fully funded by open-ended balance sheet expansion from the world's most important central banks.
- Money supply growth exploded and, with a lag, so did inflation.
- The V-shaped recovery was ignored by policymakers, and the Federal Reserve (Fed) played down inflation, a by-product of supply chain problems and re-opening demand. Commodity and goods prices were soaring, but lagging indicators of inflation, like wages, rents, and service sector inflation, remained relatively behaved at first.

It is pretty obvious to everyone, including central banks, that they made a big mistake last year. And so the central banks have panicked this year in a frenetic effort to catch up and get ahead of the inflation curve. The U-turn in policy exposes just how asymmetric the U.S. central bank's policy has become and why the current asymmetry means risks have swung from inflation to recession.

- Last year the Fed's bias was a preoccupation with employment. It closed its eyes to exploding money supply, a positive yield curve, increased commodity and energy prices, asset inflation, a booming housing market, growing market inflation expectations, and official reports of rising inflation.

- This year the Fed's bias is do what it takes to bring inflation back to target. Blind eye again; this time it seems to be ignoring the reality that ***all*** of last year's inflation signals have reversed. Money supply growth has collapsed, the yield curve is inverted (see **chart 4**), market-based real yields have surged almost 300 basis points and are at the highest level since 2009, commodity and energy prices are falling, the dollar is strong, asset markets are deflating, housing is in recession, breakeven inflation rates are falling, and leading indicators show inflation retreating. Core personal consumption expenditures (PCE) inflation is lingering at a high level, but it most likely peaked in February, even before the Fed's first rate hike.

You can feel the elastic band stretching and something soon has to give. Europe is already in an energy-induced recession; China seems unable to gather momentum.

In the U.S., the Conference Board Leading Economic Index (LEI) is contracting, implying growing recession risks. Housing has been driven into recession by the spectacular surge in mortgage rates, and it is hard to believe that corporations are not going to cut costs, given the surge in the cost of capital. There are even a wide range of indicators that suggest a decline in inflation is already in the pipeline. Breakeven inflation rates have been retreating all year. The New York Fed's own inflation gauge is in retreat, the bust in commodity prices usually correlates well with a drop in inflation. NFIB reports show firms losing pricing power quickly, and the collapse in money growth has been as significant as last year's surge. Employment is still quite firm, but even here, there are signs that things are loosening up. Job openings are retreating sharply; there is some softening weekly and overtime hours and there's a slew of anecdotal reports from major companies announcing job layoffs and hiring freezes.

Despite all this, the Fed and other developed country central banks continue to march to the drum beat of pushing rates higher and creating more stringent conditions to ensure inflation does not seep into expectations. Never before have we seen central banks move so fast and lean into a world economy that the International Monetary Fund and The World Bank Group have said is already in recession.

What is especially noteworthy is the divergence between breakeven inflation rates and nominal yields this year. Something very different is at play (see **chart 5**). Nominal consumer spending has been holding up in the U.S. this year at an 8% annualized pace, the legacy of last year's largesse and a low unemployment rate. And even real personal spending has been expanding at a 2.3% annualized pace despite stagnant real incomes. So this has been achieved with a falling savings rate, which is now quite low relative to pre-pandemic levels. At the same time, the usual big buyers of Treasuries are no longer around: commercial banks are not buying. Trade surpluses in America's allies in Europe and Japan have become deficits, so FX Sources have dwindled, and now we have central banks moving to shrink their balance sheets in an unprecedented fashion (see **chart 6**).

Quantitative tightening (QT) has only been tried once before 2018, and it did not go well. If QT upsets the supply/demand balance of the Treasury market and yields don't respond to business cycle forces pulling them lower, something will break.

Netting it out, our macro view is that last year's policy overreactions are being repeated this year but in the opposite direction. The result of last year's mistakes was inflation. The cumulative effect of this year's restriction in financial conditions is yet to be fully expressed. However, with the world teetering into recession, something seems likely to break soon.