Video Transcript: Global Macro Webcast – 4Q 2021

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January 14, 2022

More pandemic trauma marked the end of 2021, with omicron, the latest version of the COVID-19 scourge. However, beginning in December, investors began to discount the latest wave as more infectious but less deadly—and possibly the very thing needed to end the pandemic. We hope this view turns out to be accurate. In the meantime, uncertainty persists as long as the threat remains, and a return to normalcy from pandemic trauma still seems off in the future rather than around the corner. Aside from pandemic uncertainty, the main takeaway from this quarter's macro webcast is that several of the unusual economic and data trends observed during the last two years appear to be setting up for some degree of reversal, or mean reversion, which could be important drivers of investment trends this year. And if these anomalies were to completely reverse, which is not impossible, the outlook for 2022 could be characterized as whiplash.

1. Global growth should slow significantly. The U.S. ended the year with nominal GDP growth in the 12% to 13% range, which is just not sustainable. This pace of growth is a reflection of an enormous rebound out of the apocalyptic-like hole in GDP created by the lockdowns, followed by reopenings and MMT-like policies. It is not sustainable. Output gaps are narrower, and policy is retreating. A slew of leading global economic indicators are pointing lower and purchasing manager-type indexes suggest the trend to slower growth has started. The tendency will be more toward potential GDP growth trends. The issue is how fast and how far.

2. Inflation too should begin to mean revert. The extraordinary surge in prices has been global and caused by supply chain disruptions and strong policy stimulus measures in the developed world. American programs supporting income and demand were the most aggressive in the world. Correspondingly, the U.S. was the only major economy to see nominal personal consumption eclipse its pre-pandemic trend with inflation reaching multidecade highs.

In contrast, the rebound in European nominal spending remained short of its pre-pandemic trend, and core European inflation moved relatively modestly to about 2.6% from 1%. China provided very little macro support during the lockdowns and retreated quickly in 2020. Not surprisingly, CPI inflation did not go up very much and is retreating.

The worst of the supply disruptions may be over and policy measures are swinging from support to restraint. Order backlogs are improving, inventories are growing again, and executives of key supply-compromised industries are sounding more optimistic. Both U.S. and Chinese manufacturing prices-paid indicators have started to retreat. U.S. households may be shifting their consumption back to services after a nearly two-year hiatus, supplanting the online binge of consumer durable goods. Rising prices have weakened real income growth and slowed real consumption, and energy costs remain a headwind. But we know that U.S. households and businesses are flush based on money supply trends accumulated savings, and rising wage rates. As with the growth outlook, the relevant question is the time lag: How fast will inflation retreat and to what level? Higher for longer or lower sooner?

3. U.S. monetary policy is not waiting; not whiplash, but it seems to be heading that way quickly. Federal Reserve (Fed) Chair Powell threw in the towel on "transitory" inflation beginning in early November. By mid-December, the official stance of the central bank had pivoted pretty hard with the Fed rushing to

end balance sheet expansion by doubling down on the pace of balance sheet tapering and with the December Federal Open Market Committee (FOMC) revealing that members openly discussed balance sheet reduction and the prospect of three to four rate hikes. So, policy is still expansionary at this point but will have shifted a lot six months from now. The speed of the reversal in the Fed's stance is remarkable given its relentless messaging that inflation was temporary. It is not the first time that Fed Chair Powell has folded from an entrenched view. In late 2018, market pressure forced a humiliating reversal in the central bank's stance and Powell's view that the neutral rate was significantly higher. This time around, the pressure on the Fed Chair might be more political—the Biden administration's withering popularity due in part to surging inflation. When was the last time a politician asked the central bank to tighten? Markets have priced in three to four rate hikes by this time next year with the likes of JPMorgan Chase Chief Executive Officer Jamie Dimon and Goldman Sachs spokespersons suggesting more is possible. It would be quite a reversal if all this comes to pass. Shrinking the monetary base for an economy in which nominal money growth is rising is potentially very restrictive, unless the money multiplier is rising and bank lending begins to surge. Pressure on the Fed could lift by midyear with a slower economic trajectory and some improvement on the inflation front. The question may be: What is the probability of a more extreme reversal in Fed policy than is already priced in? Can the Fed achieve a soft landing?

4. Politics could be another source of mean reversion. The Biden administration's hopes for passage of its "Build Back Better" fiscal program are faltering due to the conflict between "progressive" and "moderate" Democrats. If Democrats lose control of Congress during this year's midterm election, we could end up with Congressional gridlock, which would put a very wet blanket on any new fiscal stimulus.

Following two years of unprecedented expansion, Russian and Chinese imperialism remain potential threats to growth, although we view this as more of a tail risk than our base case. A Russian invasion of Ukraine would leave Vladimir Putin in control of natural gas prices and Europe's main energy source; China reclaiming Taiwan would give President Xi control over the West's supply of semiconductors.

5. Is there an exception to whiplash? The one area of the world where there may not be much mean reversion is China. Policy support during the crisis in 2020 was muted in comparison with the West and quick to be withdrawn. Last year, the authorities took on deleveraging the property sector despite a slowing economy. The People's Bank of China's (PBOC) recent announcement of a 5-basis-point cut in the prime rate for one-year loans only drives home the point that they do not want to engineer a broad-based credit reflation. In the meantime, reliance on social isolation to control the virus could compromise growth later this year if omicron is as contagious in China as elsewhere in the world. The base case for China is a soft landing with the credit impulse bottoming, but the risks are on the downside.

Bottom line: The macro outlook boils down to mean reversion across a swath of macro variables. The rhetorical question being how fast and how far—the slower the mean reversion, the stronger 2022 looks.