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Epochal Moments and Hangovers

Twice in two years, civilization has faced an unexpected existential threat. First it was the pandemic; now it is nuclear war. It all seems surreal and crazy. It feels very unstable and seems like globalization is in retreat. The world order is transitioning from domination by a relatively benign global hegemon (at least from the western perspective) to a more multi-polar concoction of competing ideologies and interests. The late financial historian Charles Kindleberger identified these periods in history as inherently less stable. It is realistic to embrace the idea that instability and volatility are probably here to stay.

From an investment perspective, the political and policy reactions to these events and developments are as important as the events themselves—both in the short and long term. One example is the scale of the recent drawdown in global bond markets, one of the worst in nearly 100 years.

The cause of the bond blow out is complex: The most aggressive policy stimulus measures in peace-time history—at least in the developed world—collided headfirst with the supply constraints and shortages, and the related energy shock that have followed both the pandemic and now the war. The result has been booming *nominal* growth conditions in many countries over the past 18 months or so and the highest inflation rates in decades—all of which have pushed yields higher.

It is important to note that not every region of the world is experiencing the same circumstances as in the major developed economies.

- Near the end of 2020, the Chinese authorities began pulling back on what was relatively small pandemic-related fiscal policy stimulus while the Peoples Bank of China normalized money market rates quickly. Chinese bond yields peaked in November of 2020 and have been falling fairly steadily ever since. Headline CPI inflation is less than 1%.

- During 2021, central banks in many emerging countries of the world moved aggressively to reverse the rate cuts of early 2020. Several South American economies in particular saw policy rates increase dramatically well above pre-pandemic levels. This is probably the main reason why there has been no "taper tantrum" as the Federal Reserve (Fed) pivots to restraint.

- The developed world went in a different direction during 2021, led by the Biden administration. The American Rescue Plan pumped another $2 trillion in government spending programs directly into the U.S. economy, for a cumulative total in pandemic-related fiscal support of $7 trillion. The Fed—unlike its counterparts in China and the emerging world—kept flooding capital markets and the economy with liquidity up to and including almost the entire first quarter of this year. These aggressive demand measures drove U.S. CPI up to 8% from only 1.7% as recently as February 2021. The Fed was still spiking the punch bowl in March with inflation soaring. U.S. fiscal libations sum to about 30% of 2019 gross domestic product (GDP) and only ended last September. There are no comparisons for these magnitudes and actions other than war. It is hard not to conclude that U.S. macro stimulus provided in 2021 was a policy mistake of colossal proportions.

Booms follow busts, which follow booms. The main question now is how big the hangover is going to be. In our last quarterly webcast recorded in early January, we discussed the possibility of economic "whip lash." Namely, that last year's trends could reverse this year and potentially even reverse a lot of last year's trends. This scenario seems even more likely now—although how extreme a reversal in trends takes place will be affected by the scale of the pivot in macro policy and how markets adjust. But the key point is that the boom has generated a lot of inflation. Inflation robs people and businesses of real purchasing power. Trends in income and spending when adjusted for inflation are not flashing anything like the boom-like symptoms of these same measures expressed in nominal terms.

- Real disposable income has been falling since March—now less than 1% above its pre-pandemic high-water mark in early 2020.
- Real Retail Sales—a decent indicator of personal consumption, which is the driver of the U.S. economy—have been flat to down since March 2021.
- Real Durable Capital goods orders—a good indicator of capital spending—have flattened out since September of last year.

What do these divergences between trends in nominal and real activity imply?

- Sooner rather than later, we expect attention in the U.S. to turn from worries about inflation to worries about the economy. Europe is probably already in a recession. China is trying to pull out from a growth profile that is too slow and now fighting the headwinds of another viral surge in areas affecting 78% of its GDP.
- There could be a measurable retreat in U.S./Western inflation later in the year, depending on trends in commodities and energy—the latter made worse by the fallout from sanctioning Russia. How low inflation might retreat is still unclear because of wage and employment trends. By some estimates, this is the tightest labor market in recorded U.S. history, which suggests that a return to the pre-pandemic inflation backdrop may not be likely.
- A lot will depend on the Fed, which has finally decided to reverse course, although how abruptly remains to be seen. The Fed has made critical errors in judgment twice in Powell's tenure as Fed chair: First in 2018 believing the neutral rate to be much higher; and last year, hanging on to the "inflation transitory" view too long before reacting. In each instance, he held to a fairly dogmatic position before being forced to alter course by the market. Before the Fed has really done anything, markets are beginning to worry that he pivots too hard in the opposite direction as he tries to "catch-up." The market is expecting 2.5% for the Fed Funds Rate by the end of the year. The big known unknown is the impact of shrinking the Fed's balance sheet $95 billion dollars a month. It is hard to say what will happen as it is reduced, but we doubt that the runoff will be as benign as Powell suggests. That might be another reason for the flat/inverted shape in the forward Treasury yield curves.