Macroeconomic Update

Brandywine GLOBAL

Waiting for the Next Shock?

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The world is flooded with confusion and change. The S&P 500 Index and the U.S. economy have defied consensus pessimism this year. Investment hype surrounding artificial intelligence (AI) has gone manic. Europe's war keeps escalating. The Wagner Group's revolt could be a sign of even more instability. Climate change anxiety has been ramped up by the Canadian forest fires. The Organization of the Petroleum Exporting Countries (OPEC) has tried twice this year to support oil prices and failed. China's reopening has been underwhelming. The U.S. is facing massive budget deficits as far as the eye can see and a contentious presidential election race. The free market era of Thatcher/Reagan-ism has given way to populist political tribalism, big government, and industrial policies. No wonder the multi-polar world is edging out the status quo and trying to dump the U.S. dollar.

Challenging to say the least, handicapping the investment implications for any one of these developments is a major task. But for now, we still believe that the thing that matters most is inflation, despite all the noise.

Inflation has fallen a lot in the U.S. Optimism that it will keep falling is what has supported risk assets. We think it is going to keep falling, too. But the decision-makers at the Federal Reserve (Fed) are not convinced. Their job is to keep inflation on target. They believe policy rates and the unemployment rate need to go higher in order to push inflation back to target.

No one has the inside track on the inflation outlook, especially now and especially the Fed. Its credibility eroded, this is the same group of people who did not believe inflation could rise and remain as high as it did in 2022. Now they think it cannot fall without more pressure despite the second most inverted curve in history, the collapse in money supply and credit growth, and the disintermediation underway in the regional banking system. The Fed might be right but the justification for its viewpoint is mainly the inflation rate itself and the low level of unemployment. This stance implies no change in view or policy until after inflation has fallen, as was the case after inflation rose. And it is not just the Fed. Its perspective is the orthodoxy these days among western central bankers and high-profile economic commentators: higher for longer on rates.

Our view on inflation is more optimistic because:

- The financial and monetary variables point in that direction.
- Inflation is the final piece in a falling line of dominoes. What went up in 2020 and 2021—cryptocurrency, commodities, real estate, economic growth, and inflation—have retreated in perfect sequence starting late 2021 and early 2022. Now it is inflation's turn.
- We believe keeping conditions tight until inflation has receded to target is a strategy for overshooting the objective and moving straight to deflation. A lot of lip service—but perhaps not enough credence—is given to the notion of policy lags. What the Fed implements today affects the economy months or years later. The retreat in inflation seen since June of last year has little to do with Fed policy, in our view. The reaction to what the Fed has done or is going to do is yet to come.

For three years, we have stressed that post-pandemic economic developments should not be considered a business cycle. Our perspective is of an economy normalizing around a barrage of unprecedented shocks, beginning with the lockdowns and the bust. Next came the reopening and mega-stimulus. And lastly, the sudden and plunging reversal in monetary conditions. We wondered if all this unprecedented churn of excess savings, liquidity, and rising income growth as employment normalized would allow enough time for inflation to retreat and U.S. monetary policy to pull back. The worst-case scenario would be a shallow recession or below-trend growth—the economic profile more a case of sector-by-sector adjustment from the post-pandemic churn with some industries retreating and others expanding. So far, that is what has been playing out. Falling energy prices and improved supply chains are positives for growth, which offset some of the negatives. Personal income and spending growth offer the best perspective on the enormous distortions; after three years, these two measures have realigned but with a very low savings rate.

What is not normalizing and what makes the Fed's job even harder is fiscal policy. Based on my calculations using U.S. Treasury data, government spending was $6.6 trillion and rising for the 12 months ending May of this year, over $2 trillion more than in December of 2019 or 46% higher and roughly $1.2 trillion above the pre-pandemic trajectory. Despite the strength in the economy and the low level of unemployment, government spending relative to gross domestic product (GDP) is running at a pace more comparable to levels seen during recessions.

Federal Open Market Committee (FOMC) board members do not think they are done, maybe because they are fighting with fiscal policy. More things will break if the Fed follows through, and we are right in our inflation outlook. The first sign of systemic stress emerged last year in the UK pension industry. The second shoe to drop was this year's regional bank failures in the U.S. and ongoing disintermediation. The Fed's position means another shockwave is likely to hit before the central bank begins to ease up.

A World Out of Sync

The diverse conditions outside of the U.S. do not change the story to any major degree. The Fed wants things to slow; China's leaders want things to pick up; the European Central Bank's (ECB's) monetary vise already has the economy in a technical recession, but it must do more because of stubbornly higher inflation; and in select emerging countries policy is even more stringent than in the U.S., judging by yield curves. This divergence explains why global growth is uneven and argues for much reduced inflation.

China's reopening has fizzled due to feeble domestic consumption. Nothing could be more crystal clear about the state of domestic demand in China than its inflation data. According to the latest data from China's National Bureau of Statistics, core CPI is close to zero, producer prices are falling, and China is exporting its deflation to the rest of the world.

Efforts to reflate the system with public policy are compromised by a number of factors. China's augmented budget deficit is probably already over 10%, based off an April 2022 report by the Institute of International Finance. The authorities do not want to boost leverage, nor do they want to fire up property speculation. However, the priorities of President Xi are the biggest impediments to rebooting China. Under his leadership, anti-corruption, national security, oversight of private companies, property speculation, and the stability of the Chinese Communist Party have taken priority over economic growth. President Xi did a U-turn on COVID containment late last year and elevated growth as a priority in the wake of public protests. But the follow-through has been tepid.

ECB rate hikes have already led to a technical recession, but it seems likely to worsen because of the economic zone's stubbornly high inflation rate. Europe's monetary profile is horrible; banks are not lending—annual growth in lending to both households and businesses dropped close to zero in April, according to the ECB. Bank lending is much more important in Europe than the U.S. and accounts for the majority of financial intermediation. The poor lending data rhymes with the June production manager surveys, showing a generalized contraction in European manufacturing. Meanwhile, the non-manufacturing survey is barely holding above 50. One reason for the stubborn nature of inflation is fiscal policy. Roughly 800 billion euros in fiscal support have been provided to EU business and households to help offset energy costs.

Strategy

We are bullish bonds, which is expressed across portfolios through investments in Treasury bonds, mortgage-backed securities (MBS) bonds, and select emerging market bonds.

The biggest pricing anomaly in the fixed income markets is the U.S. yield curve, more extremely negative than at any time in modern history except for the early 1980s. Yield curves in some emerging countries are even more inverted. We believe the risk/reward profile warrants long duration positioning. Everything mentioned earlier points to a bull steepener in the yield curve. A Fed-provoked recession could trigger a bond rally; our base case of falling inflation and a mild economic downturn would also support the bond market but with less upside.

There is some near-term risk to the upside in yields if the Fed continues to raise rates and nominal GDP growth remains strong a while longer. However, history shows GDP itself is a poor early warning indicator of a sudden drop-off in activity, the data generally remaining firm right up to the moment it weakens.

On the currency front, the U.S. dollar is overvalued based on most metrics but not in the extreme. In addition, tight monetary policy and expansionary fiscal policy is typically constructive for a currency, which is the current policy backdrop in the U.S. Consequently, our foreign currency allocations out of dollars are on a selective bilateral case-by-case basis.

Companies have not been complaining about the strength of the dollar despite wider current account and trade deficits. Similarly, the dollar has not responded much to Treasury Secretary Yellen's admission that Americans should expect a decline in the greenback as the world's reserve currency as China, Russia, and some other prominent countries look for ways to dethrone it and escape potential U.S. sanctions.

The reality is that no other major economy has the depth of capital markets, the institutional infrastructure, and the laws that could replace dollar hegemony for now.

It is hard to picture what will provoke a meaningful retreat in the dollar this year given the Fed's determination to restore low inflation, not to mention the darkening outlook in Europe. Expectations that the euro could rally because the Wagner rebellion in Russia might hasten an end to the war seem a bit optimistic given that Putin has no history of retreat, only escalation. The threat of confrontation with NATO in the event of Russia using nuclear weapons or blowing up the Zaporizhzhia nuclear power plant suggests that there are tail risks at least in both directions. Nor does China's desire to support its economy seem overly bullish for the renminbi or, therefore, overly bearish for the dollar. Longer-term U.S. fiscal degradation could lead to massive tax increases, which would be very negative for the currency. The only positive in that equation is that most of Western world is in the same boat.

Risks

Our view implicitly assumes that monetary lags are long and variable and have yet to kick in, thwarted to some extent by the stimulus coming from fiscal policy. The other possibility is that the underlying natural equilibrium interest rate is much higher than we think. Government dissavings around the world clearly act to push up the equilibrium real rate from what it would otherwise be. If this is the case, policy is not nearly as restrictive as the quantitative monetary data would suggest, and rates could go higher. If the Fed stops prematurely under this scenario, mean reversion in the yield curve could play out in the form of a weak bond market. However, that just seems inconsistent with all the data we have reviewed.

Index Definitions: The S&P 500® is a broad measure of U.S. domestic large cap stocks. The 500 stocks in this capitalization-weighted index are chosen based on industry representation, liquidity, and stability.

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