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Four Macro States of the World – Where are we heading?

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This piece provides a conceptual framework to think about macro questions that include:

i) where do we stand in the world between four primary states - Overheating/"growthflation", Stagflation, "Goldilocks", and Recessionary/ deflation;

ii) what are the preferred (multi-asset class) investment strategies under each state of the world; and,

iii) a consideration of the most likely paths forward from each state.

For all the market's recent flirtation with stagflation, and the Fed's predominant Goldilocks forecasts, the investment strategy favored under growthflation/ overheating is favored.

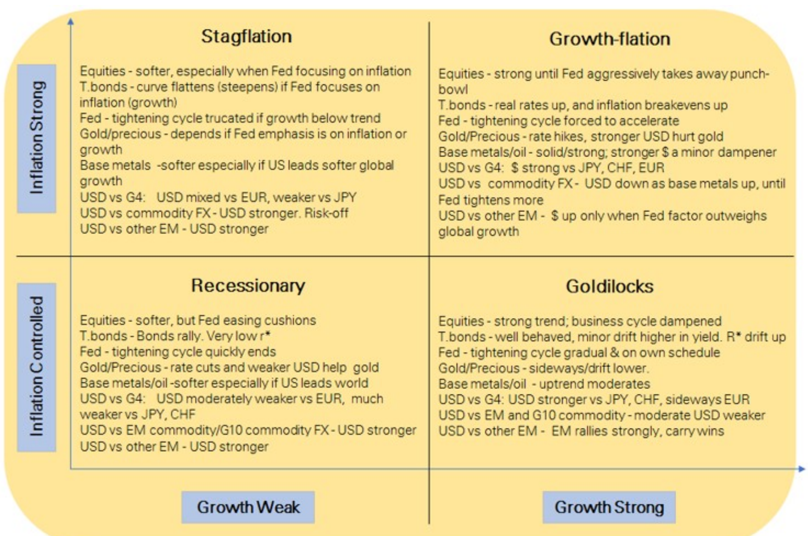
Figure 1 below provides a conceptual framework to think about macro questions that include:

i) where do we stand in the world between four primary states - overheating/"growthflation", Stagflation, "Goldilocks", and Recessionary/ deflation;

ii) what are the preferred (multi-asset class) investment strategies under each state of the world; and,

iii) a consideration of the most likely paths forward from each state.

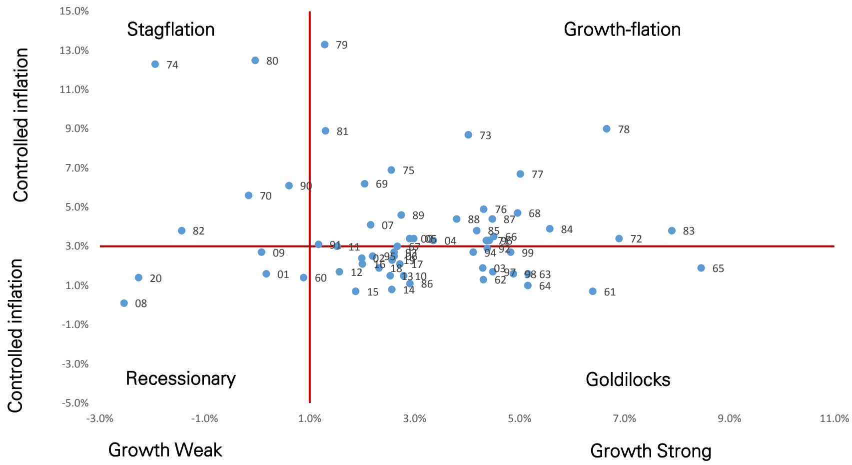
Figure 1: Investment strategies for Four states of the world



Source :Deutsche Bank

The market is of course always forward looking. It may be in one state today, but the current state may already be discounted and financial markets may be dominated by the probability weighted collective market view of the next expected state in the days and months ahead. As an example, we appear to currently be in the "growth-flation state". However, latest US data has shown inflation pressures becoming more entrenched, and growth slowing. The market is flirting with a shift toward the stagflationary state, except true stagflation is rare, and growth (with the exception of Q3) will likely not slow nearly enough. Instead, the risks are we stay in the growthflation – overheating state, and if there is a more sustained shift it is still back towards Goldilocks, which is essentially the Fed’s view for H2 2022 through their published forecast horizon.

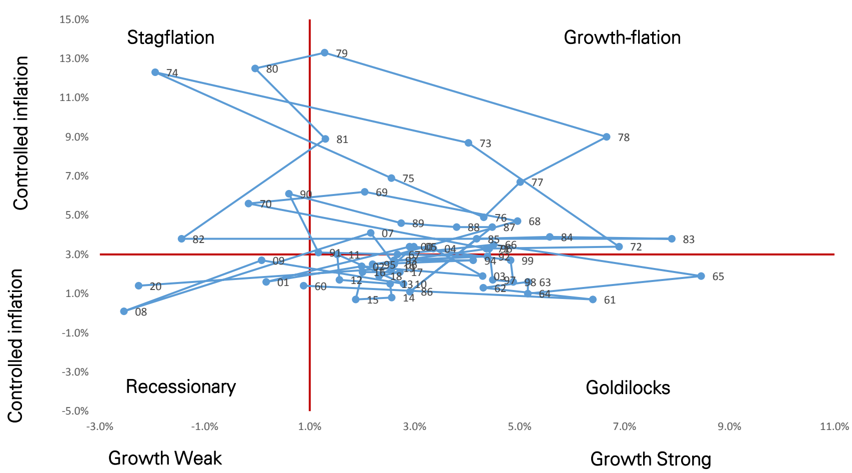
Figure 2: A US history of the Four states since 1960



Source : Deutsche Bank, Refinitiv Datastream

For all the talk of a stagflationary shift, in asset allocation terms, the dominant debate seems to be the growthflation/overheating scenario and just how much this will shift into the Fed's "Goldilocks" outlook. We are seeing the market trading more like it believes in excess inflation, but holding back from becoming aggressively negative risk appetite, because the Fed is still settled in its Goldilocks view of the world, while any rate hike is seen at least 9 months away. One question is: does the Fed pivot toward growthflation (as it has ever so gradually done of late) or does the market pivot to the Goldilocks view?

Figure 3:A US history of the Four states since 1960 - The paths between different states. Growthflation to stagflation and back to 'growthflation' is common, stagflation to Goldilocks is rare.



Source :Deutsche Bank, Refinitiv Datastream

Now in terms of history, looking at annual US data, it was decided (and there is plenty of grey area for different definitions) to define recessionary as real GDP below 1%, inflation below 3%, versus stagflation with growth below 1% and inflation above 3%; while "growthflation" had growth above 1% and inflation above 3%; and lastly, Goldilocks had inflation below 3% and growth above 1%.

To no surprise, under these definitions, since 1960, the economy has been in a Goldilocks state 41% of the time; in a growthflation state 41%, 8% in recessionary terrain; and 8% in the stagflation zone.

When it comes to stagflation as defined above, the economy tends to have isolated years in this terrain, and tends to go from growthflation to stagflation back to growthflation in alternate years, very rarely simply getting stuck in stagflation, even if much of the 1974-81 period was regarded as stagflationary.

As noted above from a practical investing standpoint, the market can flirt with multiple scenarios at the same time - much as it is doing now. What we know for sure, is that the rise in inflation in 2021 has seriously add to uncertainty as to what state we will be in, 6, 12, or 24 months from now. This is very different from 2012-2019 when we recorded a long period in Goldilocks terrain.

Note that the deep recession and clear-out of financial excesses in the Great Financial crisis, and, fairly limited policy initiatives/impulses, set the economy up for subdued growth, albeit not too far from the economy's natural rate in the 2010-2019 period. In contrast, the relative maturity of the 2021 asset cycle; the extraordinary policy impulses; and, the rapid closure of the output gap, tend to set up far greater propensity for instability and a wider range of possible shifts to the next economic state. A minimum condition to head to Goldilocks is that the Fed is right that price pressures reverse, and inflation heads towards 2% target with minimum tightening, even as the output gap shifts from negative to positive, and asset inflation rages. There is lot that has to go right here and just as much likelihood that we stay in the growthflation state until the Fed is forced to step on the brake more forcefully. Just to add to the multiple scenarios further ahead, it is far from clear how interest rate elastic economic growth will be. Currently, the suspicion is the economy is interest rate inelastic, with many corporates and households having recently refinanced.

Whether you believe the Fed or not, Figure 1 hopefully provides some guidelines, both to assess investment strategies, or look at how asset classes are trading, and better understand what state of the world the market is pricing in.

For now it still feels like the US predominantly trends in a 'growthflation' quadrant that will pivot on the Fed's actions but favors the following strategies as per Figure 1: Equities - elevated until/if Fed aggressively takes away overflowing punch-bowl; T.bonds - real rates up, and inflation breakevens up; Fed - forced to accelerate tightening cycle; Gold/precious - rate hikes, stronger USD, hurt gold; Base metals/oil - solid/strong with growth; stronger USD a minor dampener; USD vs G4: USD strong vs JPY, CHF, EUR; USD vs commodity FX - USD down as base metals up, until Fed tightens more

