Lakshman Achuthan: Inflation is Neither Transitory or Secular, it's Cyclical

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Erik: Joining me now is Lakshman Achuthan, founder of the Economic Cycle Research Institute (ECRI). Lak prepared a short chart deck to accompany today's interview. Registered users will find the download link in your research roundup email. If you don't have a research roundup email, it means you're not registered yet. Just go to our homepage, macrovoices.com. Click the red button that says looking for the downloads.

Lak, it's great to get you back on the show. Last time we had you on was August of 2021. And at the end of that interview, I said hey you're a cycles driven guy. So why don't you reach out to us when your cycles tell you, you got something new to talk about. You reached out a couple of weeks ago before the whole Ukraine situation erupted on us. And you said you had something to talk about pertaining to an upcoming policy mistake. What's on your mind?

Lakshman: Right! Hey, it's great to be back and thanks for the intro. Basically pre-Ukraine crisis, we were just staring down the barrel of a couple of policy mistake choices. It wasn't whether or not there would be one. it was just which one do you want to choose. And to kick it off, I'd say the first one that we were alluding to probably the last time we were able to talk together is that they could be tightening. The Fed could be tightening into a slowdown and therefore be risking a recession and or market crash. And I guess alternatively, if you took the other kind of door. They could kind of back off and get a bit more dovish. And then under those circumstances, they'd be risking runaway inflation and letting that get really embedded.

And so they had a very very narrow path to try and get to the proverbial soft landing. And not even I think realizing that we were cycling down in terms of growth. And since then, since I reached out, that path has become extremely narrow I would say at this point. And I think it's not too long ago, just a few days ago. So you know, after the the Ukraine crisis kind of kicked up, you know, Powell has said that he's still on track for hiking as needed to quell inflation. So here we are! I think we're staring Ukraine aside, we're staring at some volatility here in front of us from a couple of different angles from a cyclical vantage point.

Erik: Now we've had some other guests on the show telling us that they think inflation is probably peaking now and likely to subside. Although that's not my view. Before we get into how Ukraine changes all this. What were we talking about in terms of the inflation risk? Do you see this as a secular inflation risk or is it just transitory but needs to be addressed now? What is the issue with inflation? How do you see that? And then, after that, why don't we get into what about Ukraine? What does that mean for the whole picture?

Lakshman: Sure, well, so in between transitory and secular lies cyclical. So cyclical just for listeners is something that is going to be pronounced, pervasive, and persistent. It's going to last for many quarters. In terms of in this case, we're talking about inflation. And so we had all the way back in Gosh, it seems it's a long time ago, fall of 2020. That's a long time ago. And this is actually on the page two of the slide deck that I shared with listeners for today. You know, we had an inflation cycle upturn call. So, that's not a transitory inflation call. That's not a spurt and inflation call. That's a pronounced, pervasive, and persistent upturn call. And it's very very hard to remember back that far. You know, I really do mean that it's because we're inputting so much information every day. It's very hard to remember what people actually real time were thinking in the moment in September of 2020.

But nobody was talking about a pronounced, pervasive, and persistent rise in inflation back then. The bond market started to figure it out that inflation was a stickier issue in early 2021 I think it's fair to say. And of course, the Fed didn't turn hawkish until November of 2021. So there's a lot of water under the bridge there. Now, I think if you step back from like the day to day data and you look at the patterns and cycles and kind of we're monitoring the cycle very closely, and then there's the whatever the headline narrative is trying to deal with the incoming data. Now, I think the root of the problem that we have this is pre-Ukraine. Ukraine is just putting this on steroids right now. The root of the problem is the Feds lack of understanding of the inflation cycle. It's very different than cycles in the economy. So now I'm going to ancient history. I'm going to go all the way back to 2018. But there was an inflation cycle downturn that we flagged in the summer of 18. And this is the earlier the prior cycle. And this is well before the bond market became aware of the cyclical shift down and also again, it was well, it totally blindsided the Fed.

And the Feds belated response to an inflation cycle downturn in 2018 was that abrupt, what's been come to be known as the Powell pivot that happened in early 2019 following a 20% decline in the market. And in the aftermath of that event. There's some diagnosis, like what happened, you know, the Feds trying to diagnose what happened. And they totally got it. I think they learned exactly the wrong lesson about how cycles and inflation work. They came to, they kind of rationalized what happened as a fundamental structural shift to a what they would call kind of a super flat Phillips Curve that would allow the jobs market or whatever to be super tight and allow the Fed as an institution to abandon any attempt at pre-emptive tightening to control inflation. So they just really didn't need to be concerned about any run up in inflation. That's the lesson they learned from missing the 2018 inflation cycle downturn, cyclical downturn in inflation.

So that's the background for what's going on now. That utter misunderstanding of inflation cycle dynamics is now coming home to roost with a vengeance. So they think inflation is basically for all intents and purposes dead. And any spurt in inflation, therefore had to be transitory. And I think most people can remember that the Fed was saying transitory until they were blue in the face about rising inflation in 2021. And in reality, you did have that inflation cycle upturn call. I mean that inflation, an actual upturn in inflation that we had called back in the fall of the summer and fall of 2020. And so that's why the Fed was so so far behind the curve. And now, no matter what the current circumstances are in terms of geopolitical stuff, and other commodity price spikes, and all this stuff. They have to tighten monetary policy aggressively in order to quell inflation. They almost have no choice according to Powell.

Erik: So going back to 2020, you made the call for cyclical inflation, not transitory, not secular but cyclical inflation.

Lakshman: Correct.

Erik: That was happening, the Fed was slow to see that it was happening. Then we get this Ukraine situation. So now we've got a war cycle on top of everything else. You were saying previously that we've got a real problem here because the Fed is stuck between a rock and a hard place. They're really going to have a hard time balancing the need to tighten into a downturn against what could be really, you know, starting to run away inflation here, we need to do something about it. Now, it's not a question of tightening into a downturn. It's a question of tightening monetary policy into what could be incipient World War three, a major, you know, geopolitical conflict situation that has a huge negative impact on the economy globally. Anyway, we may need to tighten into that and there's really no choice. You're saying because inflation is getting to the point where it has to be dealt with. That doesn't sound like a good recipe.

Lakshman: But no, it's not. It's not a great recipe. Right. So I mean, if you would take Powell at his word, and I have no reason to disbelieve what he believes or, you know, I think he's saying what he means when he says, you know, I am set to tighten. You know, I hope the history books will put me down as a Volcker type Fed chair. And I think he was talking to Senator Shelby. He was responding to a question he had the other day. Now, going into what's happened in recent weeks in Europe. We had a high conviction call already. It just a cyclical call of slowing growth. And we started discussing that growth, what we would call a growth rate cycle downturn call publicly last September. And, you know, that view, it's normal around turning points that our cycle views are going to be at odds with the consensus. And the consensus and the Fed basically were kind of the mind that the course of the virus, right, the earlier crisis, which is the COVID crisis will determine the course of the economy. So they, you know, that's the Feds words. The course of the virus will determine the course of the economy. That is not our view at all right? I think that these business cycle dynamics are much much stronger in fact.

And therefore, but if you believe that the virus determines the course of the economy. Any unexpected weakness, what we would deem a cyclical slowdown, natural cyclical slowdown, since you know gets blamed on the virus. First Delta, and then the Omicron wave. And so on slide three of the deck, we we shared something from our spring of 2021 slowdown call. And on page four, we just have a simple chart. It's not a forecast, it's a fact. It's the coincident index growth rate which defines the economy outside our window. It's all the hard data that defines actual activity, not forecast activity. And I don't think most people realize I don't think the Fed realizes the growth in the hard data that defines the economic cycle fell to an 11-month low by early this year. That's coming off of a... So it's below a 2% growth rate now, but this is before any of the recent stuff has happened. And that's down from a peak of a very strong growth rate of 15%. And that is a you know, already it's a cyclical slowdown. The problem is that there's no forecast of an upturn, right. And then we're piling these problems on top of something which is already slowing very very rapidly.

And I think as people today are looking in the rearview mirror, they're going to belatedly see the extent of the slowdown. And then they're going to look to the Ukraine crisis and what's going on. And very quickly, and we're starting to see this, you know, I think in some headlines that there's guaranteed recession, right? There's a quick swing to the to the R word. The consensus forecasts, I think are a little bit more benign so far. They've probably not adjusted enough. They've just come down a little bit for Q2. But in again, from our vantage point, there's a much more disciplined way to monitor what's going on with the economy, which is these forward looking data that we that we look at. And And right now, we're the idea that we're in a growth rate cycle slowdown. That's, it's not even a debate, it's already a lot of water under the bridge, it's a done deal. The question is. is there any path to a soft landing or is it a done deal that we go into recession, and that's, I think going to be determined, you know in the next probably just month, a couple of months? It could, it could go either way. So that's what we've got to look forward to figuring out.

Erik: Okay, Lak so we already had this perhaps assured slowdown, that this need to tighten into that slowdown. The inflation problem and now we've got the Ukraine situation on top of all that. What does that lead to in terms of your outlook from here now that we've covered where you were before we saw this Ukraine situation?

Lakshman: Yeah well look, we have a process and this process is developed over, you know, actually, I think it's right now it's about a century. It's at least three generations going on four if you reach all the way back to defining what a business cycle is. That work was done a century ago by our predecessors. Now to to literally know, if there's a high risk of a hard landing recession, we're going to need a little bit more data. We don't have that data in hand. But we know what we're looking for. And this is in terms of forecasting, not in terms of nowcasting. Okay, so we've been studying cycles as I mentioned longer and more reliably than anyone I know. And the way we understand how recessions occur is a bit different than what people may infer. I think a general feeling is that if something really really bad happens, a negative shock, it can cause a recession. And, and that's why there's such a fixation on identifying potential shocks. And most recently, it would be like a rampant virus or a spike in oil or commodity prices driven by war. Those are the kinds of things people are focusing in on and looking at charts and saying hey, this chart lines up and it's a recession. But really, these exogenous or external shocks are part of recession dynamics. You know, they are part of recession dynamics.

But a critical part of the puzzle is the endogenous or internal market forces, the cyclical market forces. And getting a good read on these internal cyclical forces is, you know, not that straightforward. It's complicated. It's been the focus of our work for a long time. The key is really to determine when. It's a period of time, and it's not always happening. But to determine when the economy is vulnerable to external shocks. And when it isn't, there's plenty of times when it isn't vulnerable to external shocks. Now, since we're talking about war today, the last time a war triggered a US recession was in 1990. So in February, this is when I had recently joined the research group as a young kid. In February of that year, we were all alone in predicting a recession because our research showed that a recessionary window of vulnerability had already opened up. This is in February of 90'. Now, at that time and nobody will really remember this. But at that time, the economy had been chugging along, and nobody saw any recession risk.

I mean we were saying recession. Nobody else was saying recession. So on the very day that Saddam Hussein invaded Kuwait, that's on August 1 of 1990. We knew the related oil price shock would definitely trigger the recession. And to give you a sense of how long it took for the consensus to catch up. the Fed didn't cut rates until late October, three months after the recession began. So that's a real example of war triggering a US recession. And some of the key dynamics around that event. Going back further, I think most would agree that the December 1941 Attack on Pearl Harbor was a much bigger shock. Right, that's a big one. But it didn't trigger a recession. Before or time spending had a chance to kick in. It took a while for the spending to kick in. But that shock did not trigger a recession. And the reason was that the economy was in a cyclically resilient state in the lead up to the attack. There wasn't this window of vulnerability that we talk about.

Now, you could switch from, I think, you know, in my lead in when I was saying why I called you. I was saying hey the Feds tightening into a slowdown, and either they're going to get a recession or a market crash. So I wanted to talk about market crashes. Now in 87', 1987 you had a 23% drop in the market in one day. And everyone expected a recession to occur as a result of that except us which landed us on the front page of the Wall Street Journal then. And again, it's because there wasn't the cyclical window of vulnerability. In more recent years. That's all ancient history, I wanted to give you those big ones. So you get a sense for the power, the size of this idea. But in more recent years. In 2016, we went hard against a consensus that predicted that the Brexit vote would trigger a recession. And we again, because the window vulnerability wasn't open in Britain. In England, we said it wasn't going to. Similarly, India we do a lot of international cycles. I mean, we're watching 22 economies around the world. So India, we're also watching closely they, I mean, I have to say this slowly, because it's hard to fathom they demonetized 86% of their cash overnight. That's kind of a big deal right? Everyone assumed a recession would follow. But we were right in saying that it would not.

Again the window of vulnerability was not open to this massive negative shock. The Reserve Bank of India, the RBI cited our analysis equities analysis in their justification for not cutting rates as the market had expected. And sure enough, India didn't go into recession. So I'm giving a bunch of these examples. Because the critical insight that we have is not what the shock is that will trigger the next recession. But when the economy is vulnerable and answering that question of when is key. That's what we're focused on doing as well as we can. Now when we look at the forward looking indicators today, with the data in hand that, you know, that is not the case at the moment. The window of vulnerability. We go back to the beginning of our of our discussion, the Fed is essentially promising a policy mistake here, that may help a window of vulnerability to open up to know that we have to see what our indicators do in the next month or two.

Erik: Okay, so the indicators are not really showing that window of vulnerability of economic vulnerability right now. The concern is what the Fed has said you think essentially guarantees that they're going to take us into that situation.

Lakshman: Yeah and if you go to get a sense, though, I think pictures speaks a 1000 words. To get a sense, that coincident index growth rates slide on page four. the deck shows you, you know, we're not downplaying this downturn in growth. That's a serious downturn in growth. It is, you know, it's approaching zero. And that's where windows of vulnerability can start to open up. We do not have signs of any reacceleration in growth. You may remember, right, that not too long ago, people were talking of quite high interest rates, they were talking of the roaring 20s. You know, 2022 is gonna be the roaring 20s, all these other things, right. And there's just no, this is 180 degrees looking the other way.

Erik: Lak, let's come back to inflation because you said that we already have a backdrop of a cyclical inflationary impulse that we're fighting. That's for starters. Now, I'm going to make the argument that the ESG movement and what I think are some misplaced goals of the ESG movement have created a situation in energy that is a setup for higher energy prices, even before you consider the inflationary backdrop, and we agree that the inflationary backdrop is there. Now, the situation with Ukraine has the potential to dramatically exacerbate that. So I think that we could see, depending on how this whole war cycle plays out, we could see markedly higher energy costs. If I'm right about that. What is it going to mean, in terms of the feedbacks? You know, the way I look at it, there's plenty of scope here to go over $150 oil price between 150 and 250, I think is very much in range. And I do not think the economy can anywhere close to tolerating that kind of increase in energy costs. And so to me, it's a setup for a really serious problem. How does that fit your analysis? And how does that play in with everything else we've talked about?

Lakshman: Yeah. Thank you. Those are excellent points. And I agree with your observations, okay. You started off with the kind of unintended consequences I guess to put it nicely of ESG on commodity prices and, and the way that it's impacted the supply of commodities. Now, when we're doing cycle work all up until now, we've been talking about, have been referring to cycle work slowdowns, accelerations in growth, and then inflation. So we're not saying anything. We don't have a particular insight or original research on the supply side. We can observe it and we do. And ultimately, right, these prices are a function of both the supply and the demand side. And so the ESG movement has constrained the supply. So everything else being equal prices going up. We've got demand growth coming down. And so we have been in a global industrial growth slowdown for a while now. And that is why industrial commodity price inflation had past tense, been falling since last spring until recently. Even though that there's the ESG related supply constraints.

And what we have now with war breaking out, is a massive supply shock across a number of commodities including energy. But to be clear, demand is still slowing demand is not accelerating here. It's slowing here. So there's this, whatever, you know, it wasn't, I guess you have to go back and look a month or two ago, but people were looking around for this post Omicron kind of reacceleration. That's just not there. And so the idea that inflation is going to crimp and hurt is completely consistent with cycles. It's not unusual for inflation to peek inside of a recession. That's not unusual. I think you can look at it 2008, we're inside a recession. Recession begins in December of 07'. And probably second quarter, you've got oil running at 140 handle maybe approaching 150. Now, the, you know, my mentor used to joke with me, because economics is a little bit of a slippery kind of science. Right? It's not a hard science, let's say. That one of the, what he thought was one of the only economic truisms was that recession kills inflation. Okay, we can observe that if we want. If you if you look at past recessions, you'll see that but then in particular, you might think of Volcker. Right? Who gets invoked these days and Powell invoked them other day. And of course, you know, he had two recessions at the beginning of the 80s to kind of break the back of the 70s for inflation. So, I can't forecast by analogy. We don't that's not how we do it. We look at our system and sequences of leading indicators. But I could totally imagine that happening. And I would look for the indicators to confirm the leading indicators to confirm that expectation. And then of course, we'll get confirmation from the coincident and lagging data.

But the idea and I think you can anybody listening right can kind of attest to the maybe somewhat subconscious or maybe conscious experience of seeing a higher price, you know, maybe begrudgingly paying it, and maybe somehow or another rationalizing, not spending quite as much right? Because of some feeling that you had about paying these higher prices. Now, when that happens across the economy, you're getting slower demand growth, if growth at all. And we're seeing that when you look at real wages, you look at real spending, those things are cycling down hard. There's still some, you know, some semblance when you look at the nominal numbers, but when you look at the real numbers, people are already tightening their belts. And we know that that's going to happen. We think we know, we're pretty sure that we know this is gonna keep happening given what we're seeing on the radar screen. And when we get our updated leading indicators, you know, we'll have some confirmation of that.

Erik: Lak, let's translate these views to what they're going to mean for markets. Obviously, we've got a lot of changing factors, and it's impossible to make an exact forecast. But in general, let's start with equities. What does everything that we're discussing in these cycles mean for equity markets?

Lakshman: Well bottom line is, you know, relatively speaking, it depends. Everybody has a different risk profile. But relatively speaking, it's been risk off for a bit now in terms of equities. And I say this because during growth rate cycle downturns, which we are well inside of a growth rate cycle downturn. During those periods in the QE era, the post-global financial crisis era since 08'. Double digit market corrections are all associated with periods of slowing growth. And so I have a chart on page five of the chart deck, it shows just S&P 500 against cyclical downturns and the growth rate of the economy as defined by the coincident index, which is on page four. And I also threw on one of our leading indexes, this is what we call the U.S. short leading index. It leads by a quarter to over growth rate cycles and turning points. And you see the short leading index, you know, it's about as clear as it can be. It's a pronounced pervasive persistent decline. You see the growth rate cycle downturn shading has been developing for a while now. And you see, we've got a double digit correction in the in the market since earlier this year. And that is normal in this post-GFC world that we live in. So until we enter the white shaded areas, which which depict periods of growth rates, cycle acceleration, you need to be prepared that you could, you could hit significant corrections, double digit corrections. In terms of the equity exposure that you have, you can have smaller corrections anytime. But these double digit percentage point corrections are all clustered inside growth cycle downturns.

Erik: Let's move on to the bond market. Most people associate a downturn with reducing yields, but they also associate increasing yields with inflation. So if we've got unstoppable inflation in a downturn, what's that mean for bonds?

Lakshman: Yeah, this is where, you know, I'm so grateful for our kind of approach to our framework because it allows for cycles in growth to be seen independent from cycles and inflation. And if you, I think it's reasonable to kind of think about cycles in growth affecting real rates and cycles and inflation affecting inflation expectations, the combination of that should add up to overall yields, nominal yield. And right now, I think with the belated recognition of the growth rate downturn risk, right? Not for the cyclical reasons that were correct in anticipating and actually chronicling the slowdown that you see on chart, and page number four of the slide deck, real rates have come down. And inflation expectations as you can expect with the big spike in commodities, industrial commodities in particular have spiked very recently. But when you add it up with the weakness in the real rates, we've got the nominal say, 10-year yield kind of coming off the highs, right? The Fed being behind the curve, and having to make up for a lot of stuff is probably helping those real yields from falling further for the time being. And we'll have to see how those different moving parts evolve here. I think the Fed is, I think they're on tap to hike this, what is it in a week or so or it's this month? So then we'll see what the reaction is to that.

Erik: Let's move on to commodities. I think it's very interesting. We've seen in this inflation cycle, huge moves up in crude oil and copper even before we got to the war cycle then, with the breakout of this tension between Russia and Ukraine. Now we've got the the grains going through the roof. It's interesting, though gold, everybody's favorite inflation hedge really hasn't moved all that much, despite huge moves, you know, price of oil is more than doubled in the last few months. Copper, I don't know that if it's doubled in the last few months but certainly in the last 12 to 18 months. It has and, you know, we're just not even really making a new all time high on gold. What's going on?

Lakshman: That's, uh, you know, I'm not entirely sure how to describe gold in this inflationary environment. Sometimes it's counterintuitive, right? Where it'll go the opposite way than you would expect on the surface with inflation. I think probably right now in the moment, it's just your safe haven risk off asset to sit in. But with the rise with the supply and demand on commodities. So for right now, with demand where it is at the moment, if you take the snapshot, there's just not enough supply. And so the prices, you know, it's a moonshot. Not unlike, you know, perhaps, perhaps we have to we have to confirm this. But that happened in Q2 for at least for oil of 08' when you're inside of a recession and then it turned around with a vengeance right? So two things we have to watch two bogeys right? The supply and demand. Demand, we think we have a pretty good read on. It is cycling down, we know the vector, we know what's going down. The only question is, is it a soft or hard landing on demand? That's the only open question and the risk of a hard landing is growing. So then you look to the supply side. And the high prices in theory ought to be bringing on alternative supplies and we'll see how that transpires. But you know I am reminded of the old quip that the cure for high prices is high prices. And I think that we shouldn't be surprised for that to happen here. They are a lot of belt tightening in terms of people's demand.

Erik: Well Lak, I can't thank you enough for another terrific interview. Before I let you go, though, tell us a little bit more about the services you offer at ECRI and how our institutional investors can find out more about your products.

Lakshman: It's been a pleasure. Thank you very much for the time. We work with institutional clients on cycle risk management, you know, they have a lot at stake. And they have, you know, they all tend to have pretty good processes in place, but they can be taken to another level by incorporating a sophisticated understanding of cyclical risk. And having done that, at the end of the day, it's really just about conviction that the cycle turns. The tops and the bottoms, right. And so when everybody says the sky is falling, can you turn and go the other way. And we work with them to build conviction to go against the crowd, at the right time. Got a lot of international scope in what we're doing. We do have indicators for Russia and for Poland, cyclical indicators. So those are in demand at the moment.

And, you know, we don't normally name our clients, but I thought, you know, I have an okay to name one, which is TSMC. You know, we have a lot of money manager clients, we have some corporate clients too. And so they've been become better known of late during the whole COVID crisis because of their work with the products with that they have semiconductors. They've been clients for two decades, over two decades now. And from from at least from the strategy and the tactical side of things, not the technological side of things. But from the strategy and tactical stuff about managing the business. I think we've been part of their success. And, you know, otherwise we're working with a lot of fund managers, investment committees, hedge funds, big family offices. And I'm reminded, I think the crux of everything is that I'm reminded of something that Wilbur Ross observed several years ago about just the reams of information that we all have at our fingertips nowadays. And he quipped that the value of data is pretty much going to zero while the value of an insight is going to infinity. And so, I like to think for us at least, that we're really focused on the insight part.

Erik: Well Lak, give us a shout when you've got more insights and we look forward to getting you back on the program. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.