MACRO Voices
with hedge fund manager Erik Townsend

Lakshman Achuthan: Recession Still On Deck

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Erik: Joining me now is ECRI co-founder Lakshman Achuthan. Lak prepared a slide deck to accompany this week's interview. You'll find the download link in your research roundup email. If you don't have a research roundup email, just go to our homepage macrovoices.com. Look for the red button above Lak's picture that says looking for the downloads. Lak two times ago that I last interviewed you was more than a year ago. I think it was last July. We had you back on in February and I want to kind of pick up that conversation because two interviews ago you had just put on I think your recession call saying recession coming. When I interviewed you in February of this year. You reconfirm that and said, yeah, it took a little longer than expected, still coming. So I made a mental note to myself, let's wait this out six months, if it hasn't happened yet, we got to get you back on to figure out what's happening. It's been six months, is the recession that everybody's predicting still coming?

Lakshman: Yeah, I think so if in fact, it's not already here. It's, it's unusual for everybody to see a recession when it's starting. That would be really weird. Typically, people recognize recessions in the rearview mirror, ourselves included, because the indicators that define recession, output, employment, income, and sales, those all undergo a great deal of revision in the vicinity of recessions. And those revisions occur well after the fact. So you can have an instance where you're inside of a recession. And you've never seen, for example, a negative GDP, or a negative jobs growth. In the last recession, the Great Recession of 07-09, the first time we saw a negative GDP number....

Erik: Let me just interrupt you for a second there because since you're not defining the recession itself as being a negative GDP print, you're using a slightly different definition than some people use. Why are you using that definition? And specifically, why is it that you think basing the question of whether or not the economy's in recession on a negative GDP print might actually be misleading.

Lakshman: So there's two things, so there's the actual academic like, are we in a recession or not? And that's defined by the business cycle dating committee that my mentor Jeffrey Moore was the only member of until 1979. And that's based on output, employment, income, and sales, and are those indicators falling or rising as the level of their activity falling or rising? That's how you define the shaded areas that you see on charts, including the charts in our chart deck, the dark, the gray shaded areas. In terms of people's perceptions, right, you have a view on the recession, I have a view on the recession, and the market has a view on the recession, everybody has a view, are we in a recession or not? And what I'm pointing out is that people

don't recognize or begin to even think that you're in a recession until something either hits them in the face, right? It could be like a Lehman failure, or something like that or you get sharply negative GDP growth or jobs growth or something like that, right?

So I'm just pointing out that in the Great Recession, which began in December of 2007. We know in retrospect, looking at the hard data in real-time, people didn't know we were in a recession in July of '08, people did not know, people didn't think we were in a recession. That's pre-Lehman. And GDP was all positive, for example. And it was I think it was July 31, which was the first time you saw a slightly negative GDP print, I went back and looked. And then in the '70s, switching over to jobs in the '70s, you had jobs growth, positive eight months inside the recession, in the mid-'70s recession, during a period of high inflation and labor hoarding, and both of those things I think we could argue are occurring today. So that is why I believe there's this whole soft landing narrative that's so enamored with the market right now, even though I'm not convinced that we're not in a recession, we could be.

Erik: Okay Lak so it sounds like we are probably already in recession might not know it. What does that mean, though in terms of where markets have headed because so many of us thought and so many of our expert guests have really been echoing the same message of hey, the bear market bottoms not in yet. This is just a bear market rally. You know, it's gonna be over anytime soon. We're headed back down on the stock market. That keeps not happening pretty darn consistently after a lot of smart people predicted it for like a year now. What's going on here? It seems like everybody's missing something.

Lakshman: Yeah, I take your point, as we've discussed before, there can be plenty. And I'm sure other guests have met have talked about there can be plenty of bear market rallies, in particular, in and around recessions. That's not unusual. That can be easily double-digit rallies. This is a big one. Right? It's, we're 19 something percent up, I think off the low. So we're starting to be a kind of a record-breaking bear market rally if that's what it is. But record-breaking is something you could say about practically all the charts, post-COVID. There are really strange crosscurrents in the economy, post-COVID. And I think it is very confusing. You had mentioned our discussions in February, and then still last summer. And just to reset the table here, the cyclical indicators. And let's say, I'm just going to stipulate that f3 has a pretty good handle on the cyclical indicators, the cyclical indicators did fall and a forward-looking at indicators fell in a recessionary fashion. And we discussed that in July last summer. Then, subsequent to that, the Fed started to hike in earnest. Okay, so in a way that lag the effect of those rate hikes is starting now, I think, to bite on the economy itself, the actual economic activity, it can hit the markets quite a bit earlier. And it did. There's a lot of drama around that.

But the actual impact as those higher interest rates propagate through the economy, you know, it's long and variable lags. People can argue, is it shorter this time? Is it longer this time, I don't know. But here we are about a year out from when they really started to stomp on the brakes. And that's kind of a one-two punch in a way that we have this big cyclical decline in the cyclical drivers of the economy. And then the Fed and other central banks put on the brakes. And we've seen in the coincident data, slowdowns everywhere. They're not accelerations, they are

slowdowns, including even in jobs, right. I know jobs growth has been the outlier here. And it continues, but it's slowing, it's been slowing for well over a couple of years now. And the typical kind of cyclical signals that you would see recessionary signals that you would see out of jobs are beginning to show up, you have, I think you're pushing us a 6% decline in temporary jobs growth, you're seeing the workweek, not the growth rate in the workweek, the level of the workweek slipping.

And when we look at the very cyclical components of jobs, manufacturing is pretty much flat this year. And construction, the residential sides weak, the non-residential is the one that's bucking the trend. And, you know, you can pretty much think that that has to do with the fiscal stimulus into factory building and chips, and batteries and things like that, that there's been a lot of money pushed in there that the private sector has jumped on, which has created some positive activity in the non-residential construction area. So that's the lay of the land. When we look at other coincident measures of the economy, they're pretty much to the downside, and, and the deck that we brought in or sharing with listeners today, kind of speaks to a lot of those cyclical kind of observations you can make about the economy.

Erik: We talked about the recession cycle. I want to move on now to the inflation cycle, which we also talked about in your last two interviews. As I remember though is I think that you agreed with my view that we're likely in a new secular inflation to last for many years, I think you actually used the phrase 1970s era inflation to describe what might be coming. You know, I really feel the same way myself locked, but I hate it when I feel things and can't point to data that actually substantiate my feelings, especially when I get smart people like Juliette DeClerk and Jeff Snyder on this program, really laying out some pretty good arguments to say, look, this inflation that we just saw really was driven by supply chain effects. It's not a secular inflation like the 1970s. It's all blown over. It's all done with It's all behind us. It sure doesn't feel that way to me. But I don't have anything to point to really substantiate that argument. What are the cycles telling you about this?

Lakshman: Well so in there we have to unpack and have to recognize there are two different vantage points here. We can say the '70s, kind of that's a secular decade, maybe from the late '60s to the early '80s, inflation, inflationary backdrop. And that's possible. I think there is an argument to be made that that can happen. But then on top of that, you have cycles. So we can have big swings, I think during that period of the secular '70s, inflation, you would have had, maybe the cyclical lows, on inflation, around 3%, maybe a little lower, and the cyclical highs 12% or higher. So these massive swings. And I think this, to a degree, and we could talk about the Fed and Powell, I think this to a degree is informing at least some of Powell's thinking. But when there's a recession, and just for the moment, let's stipulate that our base case remains a hard landing, when there's a recession, a recession on a cyclical basis will kill inflation, it'll put it down, it's demand disruption. But the question becomes, kind of where does it trough? Where does that cyclical downturn in inflation trough? Is it down near the earlier troughs in inflation? Or is it a higher cyclical low, and in the '70s? What you saw in the inflation cycle there, when it's swinging from three to 12, and back and forth, what you saw is that you were getting higher cyclical lows in inflation as the decade went on, which became very troubling. That's on the

inflationary kind of mindset, secular inflationary mindset, really set in, to the point where there was a more popular pushback against inflation.

Early in the '70s, people weren't that bothered by it, they just weren't that bothered by inflation, having moved up. So when we switch from cyclical and right now, our cyclical inflation indicators for the US and around the world have been cycling to the downside, the US as I mentioned, maybe earlier in our February call, had kind of not been falling as sharply as other parts of the world. And so it had flattened out a little bit leading up to anticipate some sticky so-called Sticky inflation, even within the cyclical decline. And we can get into what's going on there. But you know, there's some wages and housing stuff. But on the structural now, I'm switching gears to structural inflation, secular inflation, there are several things that would argue that maybe we get inflation ends up being a little bit more problematic than in the last decade or so. One is productivity growth. I know everybody's excited about AI. But in the meantime, until whenever that makes some meaningful impact on productivity growth, our productivity growth is horrible. And just because the last reading came in a little better doesn't mean anything. When you look over time, over years, or even decades, our productivity growth for services for manufacturing and for construction is just embarrassing, it's bad. It's really, really bad. And that means, for example, today, it takes two construction workers to do the same job that one did in the '90s.

Now, there are multiple reasons as to why that's true. But that's true. And that's very, very difficult if you're trying to keep inflation down. That's a difficult reality to deal with. Construction productivity is the worst, manufacturing's in the middle, it's pretty bad. And even services productivity growth has been deteriorating quite a bit, and all of those are inflationary kind of developments, and they eat away at your long-term growth potential for the economy. Second, after COVID or with all the geopolitical stuff going on, whatever the reason, there seems to be this shift toward onshoring. Okay, so onshoring is not necessarily unclear that that's cheaper. In many regards, that could be more expensive. So that's something I would put up there is something to watch the impact on prices from onshoring. And then probably the nearest biggest thing to get around is the huge kind of HIT, we took to the labor supply in the United States. And so there are things related to COVID that have limited supply, to immigration that have limited, limited the supply of labor, and early retirement or whatever's going on with people who are right near the retirement age, whatever it is, the labor supply is very tight. And that's contributing to some of the cyclical confusion as to what's going on with the economy. But structurally, it's unclear how the labor supply all of a sudden gets a lot bigger. And again, that's kind of an inflationary floor support.

Erik: Lak, let me read this back to make sure I've understood what you've said, do you still anticipate a recession? Yes. Are we already in it? Probably. Is it abnormal to be in it and not realize that you're in it? No, that's perfectly normal.

Lakshman: Correct.

Erik: Is the inflation that we've seen really completely transitory or is it not transitory? Well, it sounds like the answer is, we really still don't know, the inflation that we've already seen

probably really was all transitory. We have a bunch of setups that you and I agree really should bring about a secular inflation. But we also have a recession call, which by your own description, even if there's a new secular inflation, the recession that's beginning now or has already begun, however, you want to think about that, that recession is going to put a lid on any inflation. We're not going to see a major resurfacing of inflation until the recession is over. So it's really not until the recession is over that we find out whether this inflation is really secular or not. But you and I are leaning toward the hunch, it is with the qualifier that we don't really have any hard data to prove that with yet. We just have some narratives like China and a what block. I think you and I are in agreement that when we start building stuff using union labor in the United States, rather than slave-raised labor in countries like China, it might get more expensive instead of less expensive. If that proves right, then it just might be that inflation is here to stay. But we're basing that on narratives, not any hard data that either of us can prove yet.

Lakshman: Yeah, I agree with you, right. So we have our we think that weak productivity or negative productivity is inflationary. We think that onshoring is probably inflationary, and we think the tight labor supply is inflationary. And those are...

Erik: And don't forget the entire planet running out of spare production capacity for petroleum...

Lakshman: All of that you're right, you're right. So all of those things are and all of those are kind of longer-term structural observations. Now, on top of that, we're mostly running for most of the world, free market-oriented economies. There's a lot of intervention by governments or whatnot in various ways to try and mess with the cycle that is part of free markets. But that cycle is more powerful, it is more powerful than any of these governments or interventions. So we're trying to see through all of that. We see cycle downturns. The reason I look to the 70s, I don't have a lot of other examples to look at. But you look at the 70s. And we can see the cycles in inflation. And I think the tell will be about the secular inflation. The tell is going to be where does the inflation cycle bottom around this downturn? Let's set aside whether it's a recession or not. There's some cyclical downturn, I think everybody knows that. The question is, where does this inflation cycle bottom before it begins to reaccelerate in a pronounced, pervasive, and persistent way?

Erik: And do you have any levels that you would associate interpretations with?

Lakshman: Well look what I'm interested in is if it is a higher low. If it's a higher cyclical low than we saw earlier. Now, earlier on, we came to almost, you know, very, very low reading from inflation, like, you know, very low single digits. So, you know, the Fed has some target whatever is 2%, ostensibly, right? So they want to get to the 2% target, you never land on it, right? They probably shoot through it and then turn back up. The question is, is that trough there higher than the previous low. Because in the 70s, what you saw is that you had, I think three higher cyclical lows before Volcker came in and really put an end to everything. And here we are in the early stages of something that might be like that, I don't know.

Erik: And the higher low that you're looking for is a higher low on the CPI print or on the velocity of money or on something else?

Lakshman: Well, it could be on consumer prices, it could be on the PCE, it could be on producer prices, those are all going to kind of trough around the same time. And I'd be interested if those troughs are higher than their previous cycle troughs. Back when we were in the low inflation period, right pre-COVID. And if they are, if they are like, yeah, that's, that's, I can eyeball that. And that's noticeably higher, then we may be setting in some kind of new inflationary base and the ingredients for that maybe weak productivity, and might be onshoring. It could be labor supply being constrained, or other types of supply being constrained. But we don't, we just don't know yet. I want to take the other side for one second, which is if we've got this really low productivity growth, which we're observing as best we can, right, it's hard to measure and all of these things, it's definitely hard to forecast. But if you're in this low productivity environment, and you've got relatively weak workforce growth, and both of those things have been present for quite a while now. Then your long-term growth potential is limited. And so that's something that may just keep activity, and even prices down, despite all this stuff. So the secular long-term or structural stuff very hard to predict, right, we can tell narratives around it. But what we can monitor much more actively is kind of the cyclical risk. And on the stick level risk for the time being, it's, it's to the downside.

Erik: Lak, let's dive into the chart deck and look for some of the data that confirms the things that we've been talking about.

Lakshman: Great, thanks. I have a whole bunch of charts here, kind of touching on a number of places in the United States and globally. We've talked about in our past conversations about labor hoarding and money illusion, and all of these things that are kind of mucking up the indicators. And making things quite confusing right now. But one of the things that I thought was quite interesting in the data, and in this current cycle is this slowdown that we're having in the service sector. And I have a chart on that in the slide deck on slide five. And typically, it's interesting in the chart, we're showing the coincident measure of non-financial services, and our leading indicator of the non-financial services sector. And that's where most people work. And I think one of the things that's been confusing people is that most cyclical indicators tend to be oriented on the manufacturing, the hard side of the economy. And we've been monitoring cycles in the service sector since the 80s. So we've been watching these cycles for a very long time. One of the things to notice is the coincident index growth rate on the bottom of the chart, it's come down a lot, but it's holding above zero. And you see that blue line has come down pretty, pretty darn hard.

Now, this is fairly typical, where it can hold above zero, if you look at the indicator in front of prior recessions, service sector growth often stays positive into the recession. And this current performance is probably augmented by this whole kind of YOLO summer that we've been having. Consumers are just by hook or by crook, they're going to indulge in travel and leisure. and we've been seeing that. I think that's kind of holding that up. But when we switch to the leading index, the kind of plunge you've seen there, it's just recessionary. There's no other way

to cut it. And so that is this big part of the economy where all of us work, and it's still cycling down. Pretty darn hard. Now you've all heard the next slide, you've all heard about how like the consumer is two-thirds of the economy. And it's definitely accounts for a lot of GDP growth. People have been the whole soft landing narrative is built around strong consumer means a strong economy, and therefore soft landing, not a hard landing. But when you look at this chart, you see that the pattern actually contradicts this completely consumer spending or personal consumption expenditures. It was definitely the biggest contributor to Q2 GDP growth. Absolutely no argument. And you see, it's been surging as a percentage of GDP in the wake of the COVID recession. It's near an all-time high of almost 71%. So you're like, yeah, the consumer is awesome. We're good to go. But the catch is that this is exactly what happens around a recession. Consumer spending as a percentage of GDP always soars in the run-up to a recession. And it typically stays in an uptrend until after the end of the recession. And meanwhile, gross domestic private investment as a percentage of GDP, like what are businesses doing, that's been falling, despite all the factory building, despite all that CHIPS act and all that other stuff, this thing is, is just plunging. This is typically the pattern you see, right going into or inside of a recession, consumer spending as a percentage of GDP is strong, investment collapses. And that's what's going on right here.

And now, sticking with consumption moving on to slide seven, we take a quick look at Apple because it's in the news. And here is kind of a snapshot of discretionary consumer spending. It's iPhone revenue globally. And so here you see a lot of growing weakness. Tim Cook said in the most recent call that and I'm quoting here, the smartphone market has been in a decline for the last couple of quarters. And it's a challenging smartphone market in the US currently. And you can really see how these have been faltering. And it's a clear cyclical downturn. The shaded areas here are growth rates cycle slowdowns, periods of slowing us growth, totally a discretionary purchase makes perfect sense, common sense in your head. Next slide. Moving on to slide eight, I want to take a stab at what's going on in the jobs market. Here. This has been a big puzzle for everybody. Jobs are strong, so the consumer is strong, so everything's great. So I've already talked about consumer spending. And we've already mentioned the jobs growth is the slowest in over two years. But still, people think it's solid.

This is one of our cyclical indicators, a cyclical labor conditions index. And it shows that the job market is hollowing out cyclically. That's how I would describe it. This index always turns down decisively before recessions. So it's really interesting to see how strongly that has dropped since last year. And again, this is from a purely cyclical directional point of view. The labor market is weakening, the way it does before recessions, even as non-cyclical factors are supporting employment, like the labor hoarding we talked about earlier. So the question we have right now, we see the cyclical impulse in the labor market. The question is, how long can non-cyclical forces hold up the labor market? In the face of this kind of hollowing out that's showing up? And that's an open question. Maybe it's an extra month or the month after that, we see the cracks starting to appear in terms of the headline jobs numbers, but this is a crystal clear picture of the direction of where things are headed with cyclical labor conditions. And, of course, it's not just the US where things have been weak.

If listeners look at slide nine, you see the problem in the second-largest economy in the world, this is China. And here we have our Chinese leading index of industrial production growth. And China is just not able to be a source of demand for the global economy. There was a lot of hope at the beginning of the year when they reopened that we would be off to the races and the recovery was here for the world. And this insight into the industrial sector of the Chinese economy really gives the lie to that narrative. And the knock-on effects from this weakness are really obvious in Europe and Germany. And then it's hitting basically the manufacturing sector around the world. And if you move to slide 10, if listeners go to slide 10, in the deck, you see the global PMIs. And that global PMI is failing, you can see the little bit of a hookup that it took at the beginning of the year. And I think that kind of hope and that upturn kind of got handed over to some of the fiscal spending. And that, in turn, is the new hope or the Yolo summer and the consumption that the Travel and Leisure people have been saying. But when we look at the global industrial sector, it is not ready to gear just yet. And you're seeing that in this global PMI. So we are certainly hopeful that eventually we get out of this downturn. But there's no light at the end of the tunnel just yet. And I think the fact that people have not recognized the extent of the cyclical weakness is probably just a matter of time. I think that's going to come to the fore in the coming months.

Erik: I have a couple of questions. Let's go back to Slide nine, which is the Chinese leading industrial production index. As we think about, you said, it seems like China didn't quite work out the way everybody expected. Well, from a narrative perspective, yeah, it didn't work out the way everybody expected. Everybody was expecting, okay, the pandemic is going to end, China's going to go back to its role of being the supplier of stuff to the whole planet. What happened instead is we've had a rapidly escalating geopolitical situation where the US is almost at war with Russia now. And a lot of geopolitical experts think that the US is headed toward war with China. Okay, obviously, China's not going to continue to be the primary supplier of everything in Walmart if we get to outright war between the US and China. So it seems to me that there's been a major disturbance in the force, that China's role in the world is changing quickly because of what a lot of people think is a coming escalation of tension between the United States and China geopolitically. As a cycles guy, how do you process a significant change in the course of world history like that? Do you say okay, I gotta go back and look at other cycles where major geopolitical events happened and compare those or do you say this is just one of the factors that drive a cycle that happens, you know, at its own rhythm, so to speak?

Lakshman: That's an excellent question. It's a great question, right? Because you're saying, hey, the rules of the game are changing. How do your indicators pick that up right? How do you factor that in? So our presumption is that market oriented economies have a cycle. That's our, you know, we are, you know, full disclosure, that's what we believe. And, and therefore, we've developed leading indexes what we think are very good leading indexes that monitor the strength of the drivers of the cycle. So not the coincident indicators, but the forward looking indicators, if those are selected well and in a diverse way, and I think that they are, that's what we spend our time doing is thinking about that, then implicitly, they ought to be picking up where the tire meets the road on the geopolitical tension, the onshoring decisions that have been made, the market forces that are in play, and we on on our economic indicators for overall

Chinese economic activity, they went up and they said, okay, the recession there is over. Mind you, that was the first recession since Tiananmen Square. Okay. Not a lot of people know that, the one they had just the year before. So we say okay, recessions over... What's going on inside of China? Okay, the service sector, that it's gearing of it because people got let out of their houses, right. But what's going on with this industrial component where they plug in to the world economy, and that never geared you can see on on the chart on slide nine, that that leading index on the industrial sector in China never got traction, regardless of the reopening, and that is a huge tell cyclically number one that we weren't off to the races on, say commodity prices at the beginning of the year. And that two, this is implicitly picking up maybe the front edge of the geopolitical tension or the onshoring. Maybe it's picking that stuff up. But it's doing it implicitly, we're not explicitly putting in a number to to make our guess, as to the impact of those developments.

Erik: Another guest who has given us some really fantastic directional calls is Darius Dale. And what he's told me about this market is he said look, we had a growth-related event already. That's what brought about the first half of the bear market, it's a credit event that's going to bring the second half. And I said, wait a minute, Silicon Valley Bank didn't count as your credit event? And he said no, because that really was a banking liquidity thing. He's talking about in credit markets, that there is some kind of disruption that brings about the next leg in the stock market. As a cycles guy, does anything resonate out of that? Are there any cycles that you're watching that are flashing something that might bring about a credit event.

Lakshman: Yeah, I would say that that observation fully fits with our last two discussions, right. So last summer, we said looked at our cycle indicators are flagging hard landing. And then you had subsequently you had the Fed, stomp on the brakes and start raising rates in earnest. Anytime you're in a cyclical downturn, credit contraction as part of that. There's inventory stuff and credit stuff, and there's all these different things that have to play through. But a credit contraction is definitely part of that. So the Silicon Valley Banks and these things will get some headlines. And you know, it is what it is. But the real credit event is that your mortgage rate is up, or that your car payment is up, or that when you go for your private equity loan, it's tougher, or you know, they're not loaning out, they've got to, they've got to fund everybody who's in their portfolio already. That's where they have to use their cash to keep them afloat to the other side of the cycle. So all of these credit issues are happening. That's why cash is king in your recession. Though, that's, that's when you can click if you have the cash to go shopping, during a recession, you can get some good deals. And so I think this cycle is definitely different where there's lots of record breaking charts post COVID, right, because of all the extremes we saw there. I think this cycle is maybe taking a little longer to play out because of all sorts of extremes post COVID and post QE. But it's not unexpected

Erik: Lak, I can't thank you enough for a terrific interview but before I let you go, please tell our listeners a little bit more about what you do at ECRI, which stands for the Economic Cycle Research Institute, how they can follow your work and what services are on offer there for our institutional audience.

Lakshman: Sure well, we do cycle risk management with institutional clients. We're probably different from some others in that we've been doing this for now. We're getting well into our third generation of doing this cycle work and we are covering 22 economies on growth and inflation. I think some of the most interesting stuff for the United States can be what's going on abroad at businesscycle.com or @businesscycle on Twitter, or Economic Cycle Research Institute on LinkedIn, and you can find us and we'd be happy to talk to anybody who was interested in working with us.

Erik: Patrick Ceresna, Nick Galarnyk, and I will be back as MacroVoices continues right here at macrovoices.com