MACRO Voices
with hosts Erik Townsend and Patrick Ceresna

Lakshman Achuthan: 2024 Turning Points

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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, registered users will 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, it's great to have you back on the show. It's been, I think, more than six months now. For any new listeners, you are Mr. Cycles, business cycles, and so forth. Let's start with an update on the business cycle as it stood when we last had you on in November. I think it was shortly after that, that you added a new call, which is described on page 4 of the slide deck. So what was the outlook back in November? How did it change with this global growth outlook that you have modified? And what's the outlook from here?

Lakshman: Thank you, Erik, for that intro. And thanks for having me back. November, this seems like so long ago, November of last year, we were talking about a tug of war in the United States, between some cyclical impulses to the downside and the forward looking data. And some non-cyclical offsets, really a lot of excess spending and whatnot, pushing it to the upside of fiscal spending. And how that tug of war was ongoing. It was keeping us, the United States, out of recession. And it remains to be seen how it would be resolved. So later, at the end of 2023 in December, we made a different turning point call. But I think it impacts kind of everyone including the United States. And we made, what we call a global industrial growth upturn call. So specifically, our leading indicators, we're anticipating that industrial production growth, IP growth, around the world for all the major economies, including all the major emerging markets, that would bottom and turn up, it's the growth rate would turn up in 2024. And so, with that backdrop, there's a little less wind in your face for different individual economies. And it really has kind of dual implications for people thinking about the macro world today. It certainly signifies a recovery in industrial activities. So, from the demand side, there's a rising demand and industrial activity related things that all fall over or flow into global trade itself. And that's a positive. The fly in the ointment in a way is that it also contributes to rising international inflation pressures due to that increased goods demand. And so that's kind of what we call the sting and the tail here.

Erik: Lak, the chart shows a number of series here one is called GIGLLI, one is called GIGSLI and what's called IPDI, what are those stands for?

Lakshman: To be fair, it's just a bunch of business cycle people making funny sounding acronyms, but I can decode them for you. The target is the industrial production diffusion index

on the bottom. And in this chart, at the end of last year is going down. And I think a lot of people were extrapolating that it would continue to be weak. The forward-looking data, the green lines, the top line is the global industrial growth long leading index. And the middle line is the global industrial growth short leading index, they work sequentially, you would like to see the long leader make a turn. And then to see it confirmed by the short leader, and you can see at the end of last year, we were starting to get that pattern in our leading indicators, they continued to develop that pattern. So, we're pretty confident about the global industrial upturn call that we've made. And you're starting to, I think, see, I mean, there's obviously give-and-take in these more coincident data, but you're starting to see that show up. I mean, PMI I know very recently was a little weaker, but they're basically up in the first half of this year, S&P Global has been picking up, ISM is down a little bit. But in both cases, you're seeing things like the price indexes coming in quite a bit hotter. Even approaching, I think, sixty in some of the readings. So there's something going on globally, with the industrial cycle, I think it's starting to pass through to some of the more coincident data. And it's not simply a supply story, we're seeing stuff on the cyclical demand side that is constructive.

Erik: Okay, so the big picture topic at hand here is global industrial growth. Seems to me like China is a really, really big part of that story. And oh, by the way, a lot of people, myself included, have been a little bit confused about exactly what China's recovery from COVID really looks like, or is going to look like because it hasn't unfolded the way a lot of people expected it to. So, I see you've got a slide coming up on page 5 here, saying China chimes in, tell us how China fits into this story.

Lakshman: On a cyclical basis, if we go in the way-back machine here in early 2023, pretty much everyone jumped the gun, and was looking for China to power the global economy and the global kind of industrial growth. And these leading indicators were like, no, not yet. You're premature here. But by the end of 2023, and you see that on this chart here, these leading indicators were becoming much more constructive. And in particular, was the industrial sector, or the export sector of the Chinese economy, it's roughly 20% of the economy that was starting to finally get some actual traction on a cyclical basis, meaning it's going to be more pronounced, reasonably pervasive and persistent. And that's what's unfolding here. So, it's part of the global industrial growth upturn. It's not the only reason for it, but there is a pervasiveness, China, even in the US and in Europe, where we're getting this kind of manufacturing activity where we're all part of the global manufacturing floor. We're all kind of gearing there a bit together.

Erik: Okay, so an upturn in global industrial production definitely sounds like a good thing. All good things have potential negative consequences, the risk associated with that. One is it could cause inflation. Wait a minute, we already got an inflation problem before we started. So where is this going to leave us, Lak, as we get on to page 6 here?

Lakshman: It's a really esoteric kind of chart. This is global, or international inflation, the target numbers are on the bottom. I think this chart, again, is from the end of last year from a client report, but you get the picture that the content of data is cycling down. So, the consensus view is, hey, it's everything's going down. We're, you know, easy peasy here. We're going to be

getting to rate cuts soon. I think if you remember back to the beginning of the year, there were many, many rate cuts priced in depending on which economy or central bank it was. And that all sounds pretty good, right? But the problem here is that we may not get back down to those very low inflation readings before we see the next inflation cycle upturn. And our forward-looking data really has started to signal, hey, we're moving, we think we're at the inflection point, is here in 2024. The inflection point on the bottom, the trough, in inflation isn't way off on the horizon. It's somewhere around this year. And when you look at the narratives around inflation, certainly there's a lot of reading the tea leaves and saying that this measure is wrong. And that component is wrong. And we've estimated this and that wrong. And I'm sure all of that is true. But the overall cyclical dynamic of inflation cycles, which now a lot of people actually look at, they tend to say inflation follows growth. That overall dynamic is actually to the upside and when we try to hear the story that the leading indicators are offering up, rather than having a preconception as to what the story should be, when we try to listen to what they're saying. It seems like part of the story, at least, is that goods inflation, the goods sector inflation, if we oversimplify, let's call it services and goods, right? So the services are higher inflation and all that but let's put that aside for a second. The goods inflation, which has been helping coincident inflation measures go down for the last few quarters, that may have run its course. And it's going up. And that's not baked into anyone's narrative about inflation being under control. So, I think part of the story here in 2024, if inflation remains sticky or moves to the upside internationally, is going to really come out of less goods disinflation and more goods inflation than people were bargaining for.

Erik: Now, there are some inflations, Lak, where the economy heats up. And the additional money that's available has some positive effects as well as negative effects. There are other inflations like the 1970s, where you start to get a runaway situation where the central bank is trying to fight it by increasing interest rates, but the damage that they do, the collateral damage that's caused by increasing interest rates to fight that inflation, does almost more damage than the inflation itself does. Is there a way from your cycles work to either anticipate or to determine after the fact on a backward-looking basis? Okay, we've crossed that threshold, we're out of regular just economy heating up kind of inflation, we're into a runaway inflation. Is there a way to know when you've hit that point? Or where you're going to hit that point?

Lakshman: I mean, it's hard to really know. But I think my closest answer from our work and our indicators would be the future inflation gauges. So, on page 6 on the international slide, we have the 11 country future inflation gauges in the middle. And I can tell you that that line has continued to edge up, it's not running away sharply like the top line, which is very much a directional indicator, the ILLFIG, international long leading future inflation gauge, that is a directional indicator on page 6, the top one. The middle one has done a more gentle upturn, but it's no less important, because it is giving us a directional call to look for a trough in inflation as opposed to continuing to decline.

Now, the problem is, and maybe this segues a little bit into the United States, which is, I have a related inflation picture on page 7. The problem is that the target, the expectation, the hope, whatever you want to call it, is that inflation is going to go down to around 2% and kind of hang

out there. And that doesn't seem obvious from the forward-looking data that we're looking at. The future inflation gauge, which really nailed the inflation cycle upturn that the Fed was late to, and it has been kind of paying the price for ever since. And then it also nailed the inflation cycle downturn, which the Fed is hoping will just continue, except the future inflation gauge stopped falling several quarters ago, and has been going sideways. And that led us to talk about sticky inflation, and so on and so forth. And now that's fully priced in, everybody's priced in for sticky inflation.

So where do we go from here? If the future inflation gauge breaks to the upside, now we've got a trough in the inflation cycle, which is higher than hoped for, it's occurring at a higher pace of inflation than hoped for. And that's historically not been great. It stayed, it means you're starting to get some floor under inflation. And many listeners have probably gotten used to, over the last decade or two, of inflation always being low. So this is a new game, to have a floor under there. And from a central bankers' point of view, a lot of their credibility is around this inflation fighting stuff. So that is what may lead them to, as you said earlier, kind of tightened so much that or can be restrictive, so much so that there's a harder landing. We don't see that at the moment. We don't see a hard landing here on the growth side, but this inflation component part of it, it could be something that upsets the apple cart, we don't know. And the future inflation gauge, let me just say that describe it that it's going, it continues to go sideways, it's been in a bit of a band, and it's kind of at the upper end of its band. Here on this chart, I'm showing you something, I'm sharing something slightly different. It's not inflation itself. Here, we have a US leading indicator, leading index of inflation expectations, specifically,10-year breakevens. And this could be interesting, you know, for different kinds of rates analysis. But it's also interesting, because I do think a couple of Fed heads or whatever, have started to talk about this, let me see where these 10-year breakeven inflation expectations are going. And this chart is a bit more recent, this is from last month. And you see the directional move, if you can, by just eyeballing, it's to the upside. So it doesn't suggest any near term relief in those inflation expectations. So again, it's kind of a roundabout way of giving a clue to the question you were asking about, when does it become a problem?

Erik: Lak, let me push it even a little farther and ask you about a bigger picture question, which I guess is a cycle question when you think about it. And that is this, I think that we face a generational risk factor, which is that there's literally no professional alive, who knows how to trade, or has any real experience trading secular inflation. All of the guys who are experts at that got their expertise working in the industry in senior positions in the 1970s. They're all in their 90s now, mid to late 90s. So they're not going to come to the rescue and be the guys who are the voice of experience who say, look, I know what to do here, I think we have a problem where the entire industry is going to just crash straight ahead into, wait a minute, even the professionals aren't sure what to do when you get a structural inflation that starts to run away to the point the central bank doesn't know how to cope with it. Now, whether or not we're really in that situation, or if that situation is coming up, is something I ponder a lot. Do the cycles tell us that? And more importantly, what are the cycles tell us about what happens when the industry has to face something that requires a skill set that hasn't been needed in such a long time that there's nobody who's ever done it before working?

Lakshman: I'm remembering a conversation with a client a little over a year ago, and it was little bit along these lines. And it's a medium sized hedge fund, which is, you know, a good chunk of money. And he was saying, I think they had like 75 something people working there. And he's like, it's me and one other guy who remember that stuff. And everybody else has been trading in this other world of low inflation, and QE and extraordinary monetary policy, all these other things. And so, they don't know what that's like. And he was kind of lamenting that. But these indicators, I think, give us some bearing. I'm not saying they're the Holy Grail, but I think they give us some bearing. And the reason I say that is because the indicators, on a directional basis, indicators of inflation and growth in this case, I'm saying on a directional basis, they've withstood some massive structural change over more than a century of cycle experience in the United States, and well over half a century of cycle experience internationally. So, we definitely are in a strange, seemingly new world. And it's hard sometimes to get your bearings when the level of debt is in the 10s of trillions, and that could ramp up very quickly and there can be extraordinary policy approaches and all kinds of things. But the inflation cycle and the business cycle or the economic cycle, as long as we are in an environment that is dominated by free market oriented activity, those drivers of directional turns are alive and well. You know, I think sometimes we wait and see, are the bond market vigilantes coming back or not? Or, are they still asleep? Are they back? Where are they? Time will tell. But, for example, this one indicator here on page 7 is telling us, inflation expectations 10-year breakevens, they're not going to fall. Okay, and how do you deal with that? That's a different world, you have to pay interest to hold inventories. You've got to pay interest to refinance your real estate holdings. Right? These are new ideas, and it could, in theory, squeeze your margins unless you're Nvidia, everybody else is going to squeeze their margins. So that is an interesting world to inhabit. And it's good to have some way of navigating. And so, our proposition here is that we may not know exactly what's going to happen, but we think we're looking the right way.

Erik: Lak, you've got a title on page 7, which says US inflation expectations are likely to rise. I happen to agree strongly, I think they're going to rise a lot. But I want to understand what you think when you say they're likely to rise? First of all, why are they likely to rise? Is it just the data telling you that or is that a subjective opinion as well? And how much are they likely to rise? So, are we talking a little bit or a lot?

Lakshman: I can have a subjective opinion that there's a whole bunch of things that have happened, like lots of money sloshing around or some structural shifts or geopolitical things that are really putting a big secular floor under inflation. But those are subjective, right? And that's okay. There's nothing wrong with that, I've I have a little bit of experience, so maybe that's a worthwhile view. What you're looking at on the chart is something different, you're looking at a much more objective, forward-looking leading indicators of inflation expectations, that's the top line. And the reason for being of that line is that it should turn ahead of cyclical turning point in 10-year breakevens. And when we try to objectively assess whether the leading indicator, not subjectively but objectively assess, has that leading indicator turned, we ask well, okay, how pronounced is the upturn in the leading indicator? How pervasive is it in terms of the components going into it? And how persistent is it? And compared, and when we ask those,

what we call three P's, Pronounced, Pervasive and Persistence. How much of that is presenting itself compared to past cyclical upturns in the leading indicator? And if the answer is, hey, I can check the box, yeah, it is persistent. Yeah, now it's pronounced. And when I look inside of it, that's proprietary, but when I look inside of it, yeah, it's pervasive, the majority of the inputs are pushing it to the upside. Now, the leading indicator has objectively said directionally, that expects, or we should expect the target to move in concert. That's all it says. It actually doesn't have a great deal of information about the magnitude of the move in 10-year breakevens directionally up on a cyclical basis. So that means it'll be the target. In this case, 10-year breakeven should have a pronounced, pervasive and persistent cyclical rise. That is the expectation, but how pronounced, I can't dial it in that clearly there, I'm afraid. That's not the strength of the indicator.

Erik: Lak, let's talk about precious metals and gold in particular, it seems to me like something's changed. First of all, the mining shares have absolutely not responded, as the price of the metal has moved higher. But furthermore, as we look at the gold market itself, we see that the correlation to the dollar index, which used to be strongly inverse, isn't really there the way it used to be. And it seems like everything's just trading on to a different drummer. What's going on here? Is there something that the cycles data can tell us about why gold seems to be on a different agenda than it's been on in the past?

Lakshman: That's a great question, we don't have an indicator that targets gold or a specific price like that. But having said that, a couple of things come to mind. One is, going back to the beginning of our discussion, the global industrial growth upturn call is a bullish call for commodity price inflation. And while gold is certainly special and precious, and not necessarily an industrial kind of thing, it is related and it works as a little bit of a hedge there as that whole sector moves up. That doesn't hurt it. I think you've got, with the Global Industrial upturn call, it helps emerging markets, and they're certainly interested in gold as something to buy as they're more prosperous. But I think also, you've got a kind of a layering each of these cycles, these extraordinary policy reaction functions, right? Where, it's always, whatever it takes, it seems to be the reaction out of central banks in particular, when the economy weakens. And so, there are certainly soft landing versus hard landing kind of concerns out there. There were some recessions in other parts of the world. And each time you go from, I think it was like post GFC, our debt went up a lot, maybe almost to double digit trillions. And then post COVID, I think we're sitting in, I don't know, I'm losing count. But is it like 34, or something trillion? It's pretty big, right? And so you have to wonder, just how much of that you want to be a part of, and gold is a hedge on that. I think more holistically, those are my thoughts. Cyclically, I think, global industrial growth or inflation hedge, probably support gold to a degree.

Erik: You mentioned, the central bank reaction function. So let's talk about that next. It seems to me like one of the themes that's going on right now is that central banks around the world are under increasing political pressure. The Fed claims to be completely independent, but boy, there's been some pressure for them to cut, even though it seems like inflation indications would suggest, if anything, a hike is what ought to be on the table. Meanwhile, the ECB is widely expected to cut, and I think that's a function of political pressure. Your call, as I've understood it

from this interview, very much echoes what Jim Bianco has told us, which is inflation is probably already bottomed. The bottom is in behind us. So why would you be cutting in that environment? Because politicians threatened that if you didn't, you're not going to be Fed Chairman anymore. That's the only reason I can think of. Do the cycles tell us anything? I don't know, if you have like an inflation year politics cycle that tells us when to expect silly season to have crazy effects on statistics that are otherwise reliable?

Lakshman: Well, it's interesting, right? I mean, one way to get elected is to give people stuff, right? It's not that complicated. So, people do that. And I think it actually happens on both, you know, all over the political spectrum, that kind of basic logic is at play, which isn't great if your job is to kind of have low and stable inflation and decent growth to support jobs, which is in the United States, the mandate. And so, I think you're 100% correct that all these central banks are run by human beings, I think for the most part, and so whether they have the wrong models or not, there's another debate, but they're certainly subject to how people feel about them. I think it's very hard for them to go against the grain.

You mentioned earlier that a lot of people haven't had experience with secular inflation. And hopefully, people have read about the 1970s. And you had Arthur Burns in the beginning parts of the decade, which was an inflationary, kind of secular inflation. And you had Paul Volcker toward the end and into the early 80s. And that was an interesting decade. And I can kind of paint a mental picture here. From the late 60s into the early 80s, inflation averaged 7%, just about like 6.9%. And I think the low in the inflation cycle might have been just below 3%, and the high was approaching 13%. So huge swings in the cycle. And there were, I think, three big ones, three big troughs, and then three big peaks in inflation over that decade. And there were a bunch of recessions in there. And the pattern that comes out in that secular inflation with, say, three inflation cycles in it, is that you had higher lows in the inflation cycle. And so if we go earlier in our discussion here, I'm kind of warning about that, saying, hey, everybody thinks we're going to 2% are going to hang out and stay there. And there's a reasonable narrative here that we don't make it there, and we trough before that. And then cycle to the upside, we have to watch the future inflation gauge. So that's where inflation starts to get embedded in, and it got embedded in, in the 70s. And it's interesting, the popular kind of mood, in the first half, roughly, of that decade, inflation wasn't something people were like continually screaming about. They were upset here and there. But there are some jobs growth, and you're like, alright, you know, there’s this kind of money illusion where nominal things were going up. And you weren't so focused on what was happening on a real basis and inflation adjusted basis. But toward the end of the decade, when inflation was really up there in those double digit numbers, that gave the cover in a way for Volcker to be kind of the adult in the room and really clamped down on inflation. And even then, he gave in. And he had a lot of intestinal fortitude, let's say, but he still gave in and had to raise rates again, which contributed to the 1981,1982 recession, which was a very long recession, it was over a year and a half. And that finally broke the back of inflation. I don't think people really appreciate all that. Some people may, but on the day to day kind of discussions that you might hear in the various narratives, I don't think that that's really fully understood.

Erik: Lak, let's tie this all together now. As we go forward, which indicators should we be paying attention to? What information should we be looking to derive from them, keep our eye on what?

Lakshman: As bifurcated as the economy is, some call it a K shaped kind of economy where the upper part is doing well and lower income is really getting squeezed by the inflation we've been talking about. It all adds up to continued growth. That is our expectation for the next couple of quarters. And on the inflation side, that's the one, I can't take my eye off of that, because of what we talked about with the International inflation bottoming and likely moving to the upside, odds are that the US does that too, they tend to move in sync. But to really make that call, we have to watch if the future inflation gauge breaks out of this range that it's been in and starts moving to the upside. I can't predict the predictors as much as I want to. And so, I try to stick to my knitting. I'm watching it closely. I think that the other kind of thing to watch, as you hopefully get a little bit of a break this summer, is the story around goods inflation, because I think the everything-is-happy-and-don't-worry-about-it crowd really presumes that goods disinflation is going to continue to be a component of everything being okay. And with the Global Industrial upturn call that we've made, and we feel pretty good about, there's a demand, on the demand side of global industrial activity. And so, trade in different types of early inputs and goods themselves are going to be moving to the upside. This is even showing up in China, by the way, where the kind of deflation fear is really not on our radar screen. It's not what's happening there. So steady as she goes, try to take a break this summer. But keep an eye on that forward-looking inflation data, which I'll be reporting on.

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, what services are on offer there and how our institutional listeners can find out more about your services.

Lakshman: We work with asset allocators, different types of fund managers, certainly on rates as we've been talking, and on other risk on assets, and also some C suites, global C suites and it's all about direction. The main thing that we add to the decision making process, be it in asset management or otherwise is am I looking the right way? You know, how do you not get hit by a bus? That's what we're really adding in and we work with clients to kind of fit that information into their process, and it's a lot of fun, I must say, I enjoy it.

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