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MACROCOSM

The Fed/China Doom Loop

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China's lockdowns are doing the Fed's demand-side work – but adding to inflation.

We got to feel smart for a little more than an hour last Wednesday. On Monday we had laid out what the Fed must do at the May FOMC to put the bottom in for stocks – to back off the ledge of "whatever it takes" inflationphobia and rule out a 75 bp rate hike (see "So Six Questions for Jerome Powell" May 2, 2022). After the meeting we declared victory and equity markets rallied strongly (see "On the May FOMC" May 4, 2022). But that didn't age well. *The morning after, everything started to go terribly wrong, with no apparent reason. So if there's going to be a bottom for stocks, it's going to have to be lower than the one before the FOMC meeting.*

- *What happened?*
- There's been no specific event shock. *But from talking to clients, we pick up a strong consensus that the matter of concern is the ongoing lockdown in major Chinese cities in the face of an Omicron case-wave. But we've had lockdowns before, so why all the concern?*
- *Because this is the first lockdown in the pandemic during which the Fed has committed itself to what amounts to a doom loop.*

First let us say that *we have no idea why Chinese authorities would engage in harsh lockdowns*. For two years now we have led the charge in proving quantitatively that lockdowns have no revealed capability to control either spread of Covid or fatalities resulting from it, yet they do significant harm economically and in other spheres of public health (see, among many, (see "The Failed Experiment of Covid Lockdowns" September 1, 2020). *Surely Chinese officials can see the same data we see. And they can also surely see the history this year of sharp but brief Omicron case-waves in various countries* (see "Data Insights: Covid-2019 Monitor" May 10 2022) – *waves that ended quickly despite the fact that, in most jurisdictions, lockdowns were being eased, not tightened*.

Second let us acknowledge that economic and public health data coming out of China is suspect at best. We have no idea the true size and scope of their current Omicron wave – or whether it even exists. For that matter we can't even be sure that the lockdowns reported every day are real or "fake news" (and let us not forget that, if the latter, the faking could come from China, our own media, or both). If the pandemic experience has taught us anything, it is to trust nothing and nobody. *But we do see a sharply*

Update to strategic view

US MACRO, FEDERAL RESERVE, ASIA MACRO, US STOCKS, US BONDS: A less hawkish FOMC failed to put a bottom in for stocks because of fear that the Fed is in doom loop as China locks down its large cities. Lockdowns will slow growth, which the Fed wants to see; but they will create scarcities that will inflame inflation, which the Fed does not want to see. That could cause the Fed to tighten more aggressively, doubling down on the anti-growth impulse imparted by the lockdowns. Powell is aware of the problem but has not articulated an answer. China's case-wave is already receding, so lockdowns could end shortly. S&P 500 forward earnings topped two weeks ago, but it's all due to just Amazon. Credit spreads are widening, masked by high oil and gas prices. The Treasury yield curve has come out of inversion, thanks to a back-up in real yields that has taken the pressure off of market-implied inflation expectations. The S&P 500 Equity Risk Premium is about neutral, reflecting the markets' dependency on headline resolution of real-economy risks.

weakening Chinese currency and a falling stock market – however, that said, there's nothing particularly unique about that right now on the global scene.

- *But the problem is that, assuming it's true, Chinese lockdowns are going to lead to further and longer-lasting damage to global supply chains in goods, which will diminish global growth.*
- *Ordinarily, the Fed would never tighten policy in face of slowing growth form an exogenous shock like this.*
- *But this time is different. The Fed is, rightly or wrongly, deliberately trying to dampen demand in order to rein in inflation* (again, see "On the May FOMC"). *It can't say so, but likely welcomes the blow to growth from China's lockdowns as doing some of its work for it.*
- *But no! Whatever work China's lockdowns do to assist the Fed in that direction, they undo by creating scarcities in goods that will contribute to more, not less, statistical inflation.*
- *It's a doom loop. When statistical inflation rises due to scarcity of Chinese goods, the Fed – it seems at the moment – will tighten all the more, inflicting on the economy a double-blow to growth, China's and its own. And the more the Fed damages growth, the fewer entrepreneurial resources will be devoted to actually solving the problem in the high-resolution world of global supply chains, as opposed to the low-resolution world of top-down economic policy-making.*
- *There are two ways out.*
- *One, China can end its pointless lockdowns.*
- *Two, the Fed can declare that the China lockdowns are a temporary – they will never use the word "transitory" at this point – shock to prices that can be ignored in policy considerations.*
- *We're not sure at all that the Fed has the political will to make such a declaration.*

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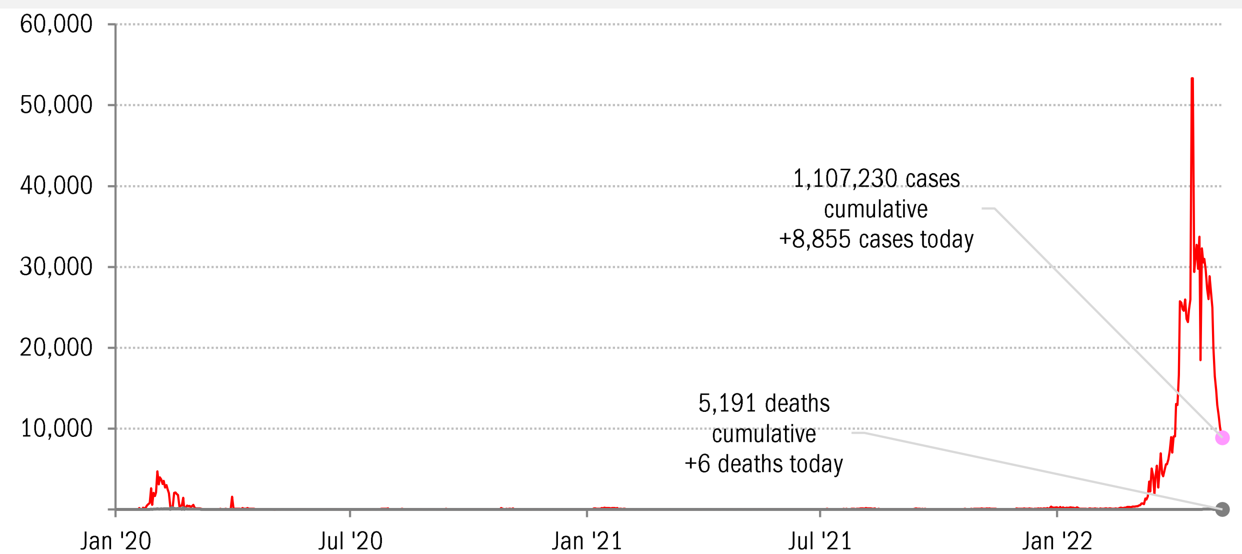
[About us]

China (excluding Hong Kong) COVID-2019 reported cases and fatalities.



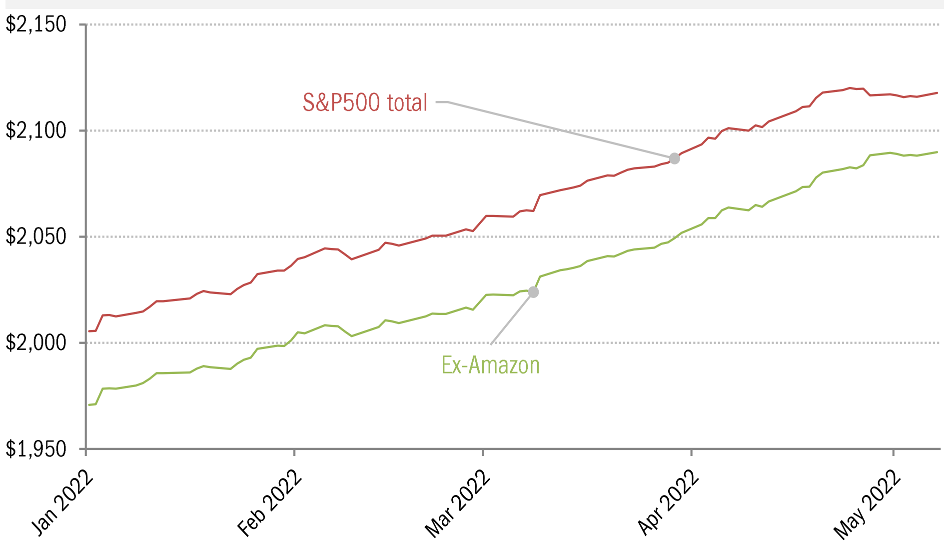
Source: Johns Hopkins, TrendMacro calculations

- Fed Chair Pro Tempore Jerome Powell was asked about it [in the press conference following last week's FOMC](). The reporter didn't ask the question as pointedly as we would have – but pointedly enough, apparently, because Powell's answer was evasive word-salad about the labor market and inflation expectations, ending up moving on by saying "it puts any central bank in a very difficult situation." *Well, at least he's thinking about it, and sees it as a problem.*
- *Whatever the Fed does we do know that China's lockdowns will be short-lived, because without exception every nation's Omicron case-wave has been short-lived. Indeed, it has already substantially rolled over in China (please see the chart on the previous page).*

In the meantime, *there has been a sudden change for the worse in the posture of a number of indicators, formal and informal, that we rely on to anticipate recession*.

- *Our most trusted is S&P 500 bottom-up consensus year-ahead forward earnings.*
- *Forward earnings have topped at $2.120 trillion on April 26* (please see the chart below). More accurately, we should say that today they are $2.117 trillion, $2.4 billion below the prior all-time high. That's not a big decline – and *it is more than entirely due to a single company, Amazon*, whose forward earnings have been downgraded following their most recent earnings report two weeks ago by $9.59 billion. *Take Amazon out, and S&P 500 earnings are in fact at all-time highs still. So technically it's too soon to call for a recession with this indicator.*
- Of course a good question is whether Amazon's earnings miss that drove the forward earnings downgrade is indicative of a sudden drop in economic activity – or whether it is, instead, a salutary sign

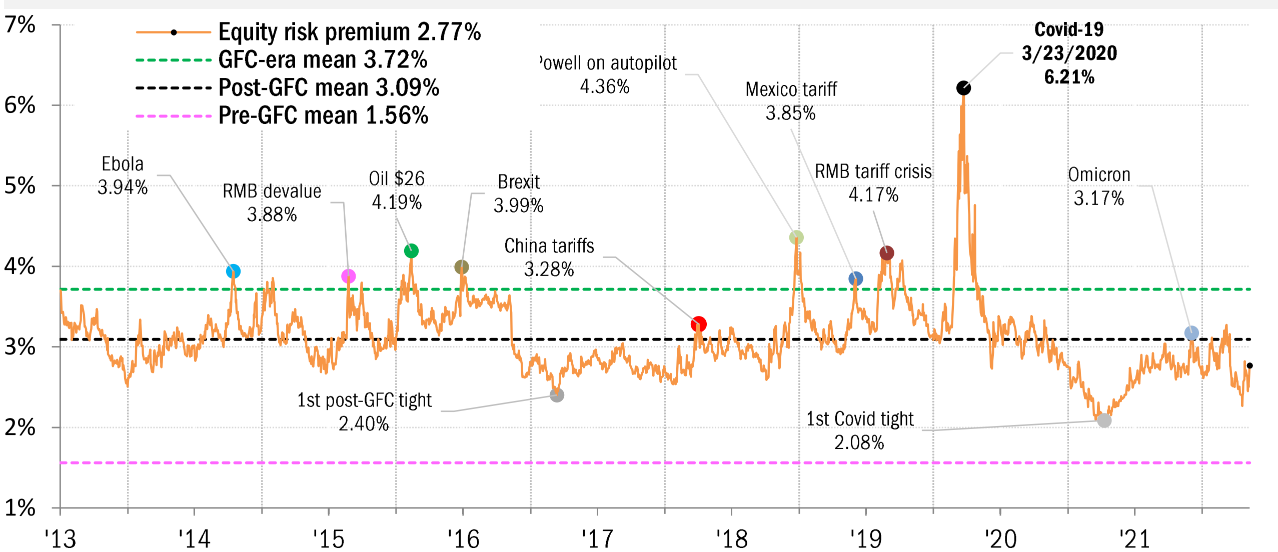
S&P 500 consensus bottom-up year-ahead forward earnings



Source: Bloomberg, TrendMacro calculations that consumers prefer to come out of lockdown behaviors and engage in in-person commerce again. We are inclined to presume the latter. Surely that's the message of Netflix's drop in subscribers last quarter.

- We have the choice of whether or not to be worried about the sharp drop in the valuations of so-called "growth stocks" (the S&P 500 Growth Index is down 24.1 year-to-date) in relation to so-called "value stocks" (the Value Index is down only 7.6%). We can report that many clients are worried about it.
- But we are not inclined to fully attribute it to falling growth expectations. We predicted it at the beginning of the year before the emergence of any of the threats to growth we're talking about here, thinking of it as nothing more than a long-overdue realignment of value relationships (see "Boom On..." January 4, 2022). It seems to have become something of a speculative purging at this point, but that's not unusual when value relationships realign.
- We also closely follow non-investment grade credit spreads. They have been creeping wider all year, perhaps with some additional widening masked by the excellent performance of energy-related issues, thanks to this year's higher oil and gas prices. This not only points to a growing risk aversion, but also to the rising price of entrepreneurial capital.
- We are not a big fan of the yield curve. Inversions of the 2-10 Treasury curve always calls the top too early by many months or even years – and then it gives a false all-clear signal just at the top (see "Video: What you're not hearing about the flat yield curve" March 22, 2022). *It inverted briefly several weeks ago, and now has widened out somewhat* – is that the historical pattern in an accelerated time frame? Possibly. It has our attention.
- We are relieved to be able to note that most of the steepening has come from the real component of nominal Treasury yields, not the

S&P 500 Equity Risk Premium (forward earnings yield minus 30-year Treasury yield)



Source: Bloomberg, TrendMacro calculations inflation-compensation component. First, that means *inflation expectations have stayed very well anchored*, after what appears to have been a false alarm several weeks ago (see "Video: What you're not hearing about inflation's dead canary in the coal mine" April 25, 2022).

- Second, we interpret rising real yields as a sign of improving growth expectations (falling real yields, like we saw beginning in 2020 with the onset of the pandemic, imply the opposite). Set against the many other indicia of diminishing growth expectations, we find this comforting.

While all this has played out amidst a great deal of volatility in prices and news-flow, it's strange that *the S&P 500 equity risk premium is set pretty much at neutral* (please see the chart on the previous page).

- There is nothing in the ERP that is jumping off the chart, grabbing your collar, and commanding you to buy the dip. On the other hand, even with long-term Treasury yields having backed up considerably, narrowing the ERP despite an already substantial correction, there is no mandate here to interpret stocks as over-valued.
- We note that the Omicron panic last November, and the Russian invasion of Ukraine in February, both failed to vault the ERP to levels that would ordinarily make stocks seem irresistibly cheap. *We interpret this, despite all the present uncertainty, as indicative of a great risk tolerance in global markets. Investors demand a smaller premium to bear risk now – arguably, to a fault.*
- *The ERP's in-between non-committal posture very much reflects how we feel at the moment – and we say "feel" very intentionally, because the objective data is so hard to interpret now.*
- *There's insufficient panic to buy the dip right now on speculative grounds alone. So we await the right headline – some combination of China and the Fed pulling out of the doom loop, or even (yes, this is still a thing) peace breaking out all over in Ukraine.*

Bottom line

A less hawkish FOMC failed to put a bottom in for stocks because of fear that the Fed is in doom loop as China locks down its large cities. Lockdowns will slow growth, which the Fed wants to see; but they will create scarcities that will inflame inflation, which the Fed does not want to see. That could cause the Fed to tighten more aggressively, doubling down on the anti-growth impulse imparted by the lockdowns. Powell is aware of the problem but has not articulated an answer. China's case-wave is already receding, so lockdowns could end shortly. S&P 500 forward earnings topped two weeks ago, but it's all due to just Amazon. Credit spreads are widening, masked by high oil and gas prices. The Treasury yield curve has come out of inversion, thanks to a back-up in real yields that has taken the pressure off of market-implied inflation expectations. The S&P 500 Equity Risk Premium is about neutral, reflecting the markets' dependency on headline resolution of real-economy risks.