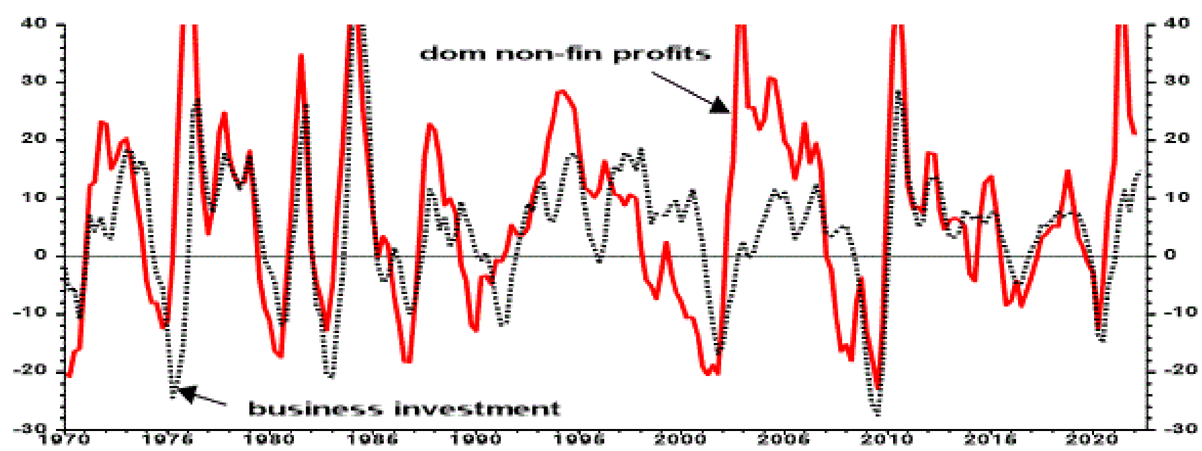
Will this be Multi year tightening cycle?

PineTree Macro

- One of the indicators of recession, US ‘business investment’ downturn is just about to begin as corporate profits start to decline.
- As per Bridgewater Associates, we are in 1st phase of multi year tightening cycle to address after effects of policy decisions. But, markets seem to discount this as only one tightening cycle which going ahead may hold them by surprise.
- The coming recession could bring only a temporary respite to the secular upward march in both short and long interest rates, as falling commodity prices cool down CPI and provide Fed respite to return back to slashing rates/QE, despite Core CPI remaining well above target.
- China unemployment problems contrast sharply with booming post covid markets in US; wherein, with the hiring problems companies faced last year, it seems unusual that companies will fire the workers this recession. Recessions in developed economies (ex-Japan) are normally not caused by falling consumption; but, by swings in business investment cycle as companies face falling profits & margins.
- In normal times, business investment contributes 1-2% to GDP growth. But in recessions, where the dotted line in the chart below falls to or below zero, the red line totally overlays it which essentially means recession is entirely caused by lack of new business investment.
- As Central bankers pursue dual mandate, they will be forced to choose between economic contraction or high inflation culminating into long periods of too low growth or too high inflation i.e. Stagflation.

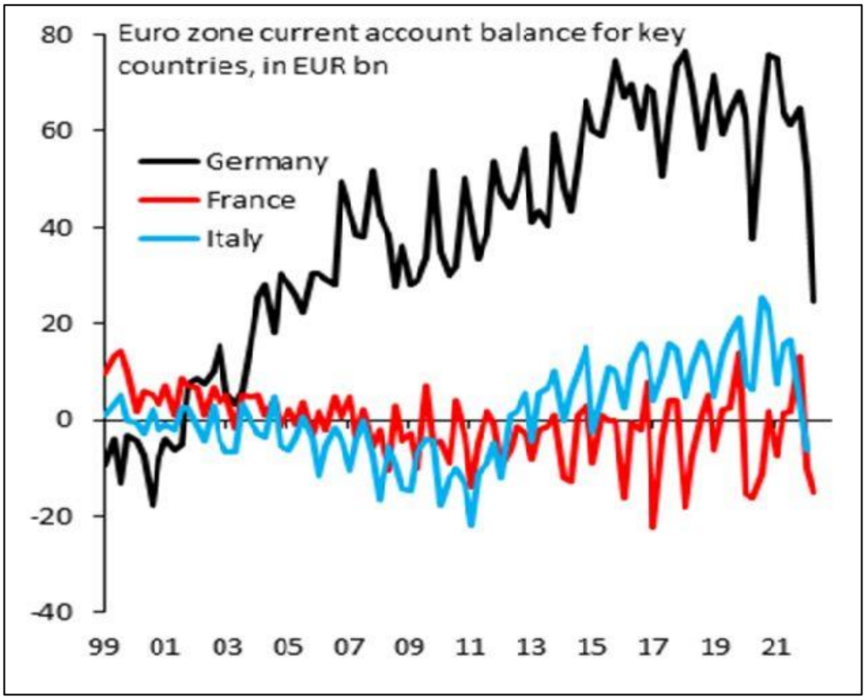
Source: Albert Edwards

US whole economy profits usually lead the business investment cycle (2qtr mav, yoy%)



Source: Datastream, (I use domestic non- financial profits as it is the main driver for domestic business investment)

Asset returns are driven by how conditions unfold in relation to what is discounted. A second tightening cycle is not discounted at all and presents the greatest risk of massive wealth destruction.



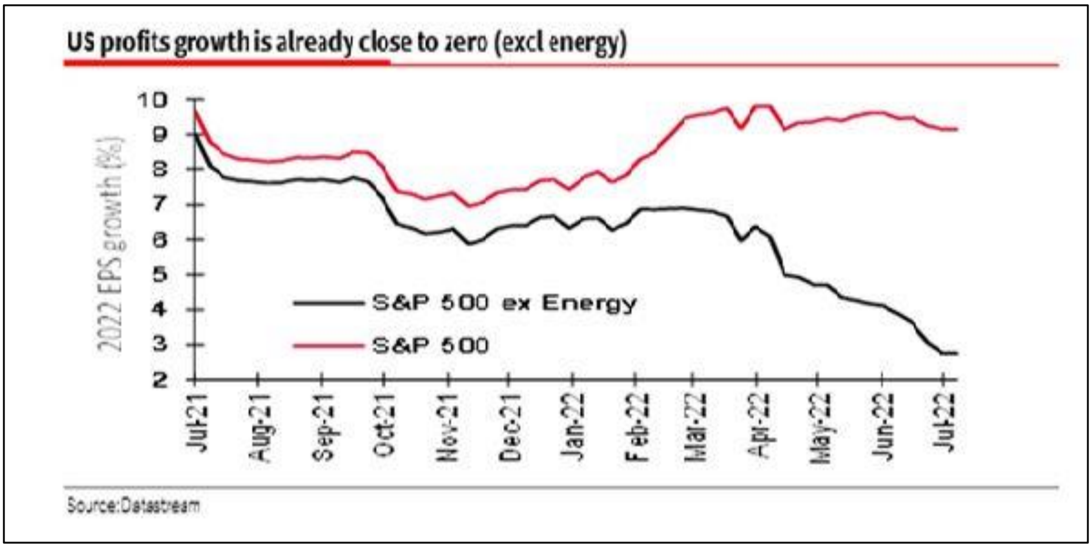
Eurozone in big trouble

The Euro zone is in big trouble. The German current account surplus is back to levels last seen in the early 2000s, when Germany was the "sick man" of Europe.

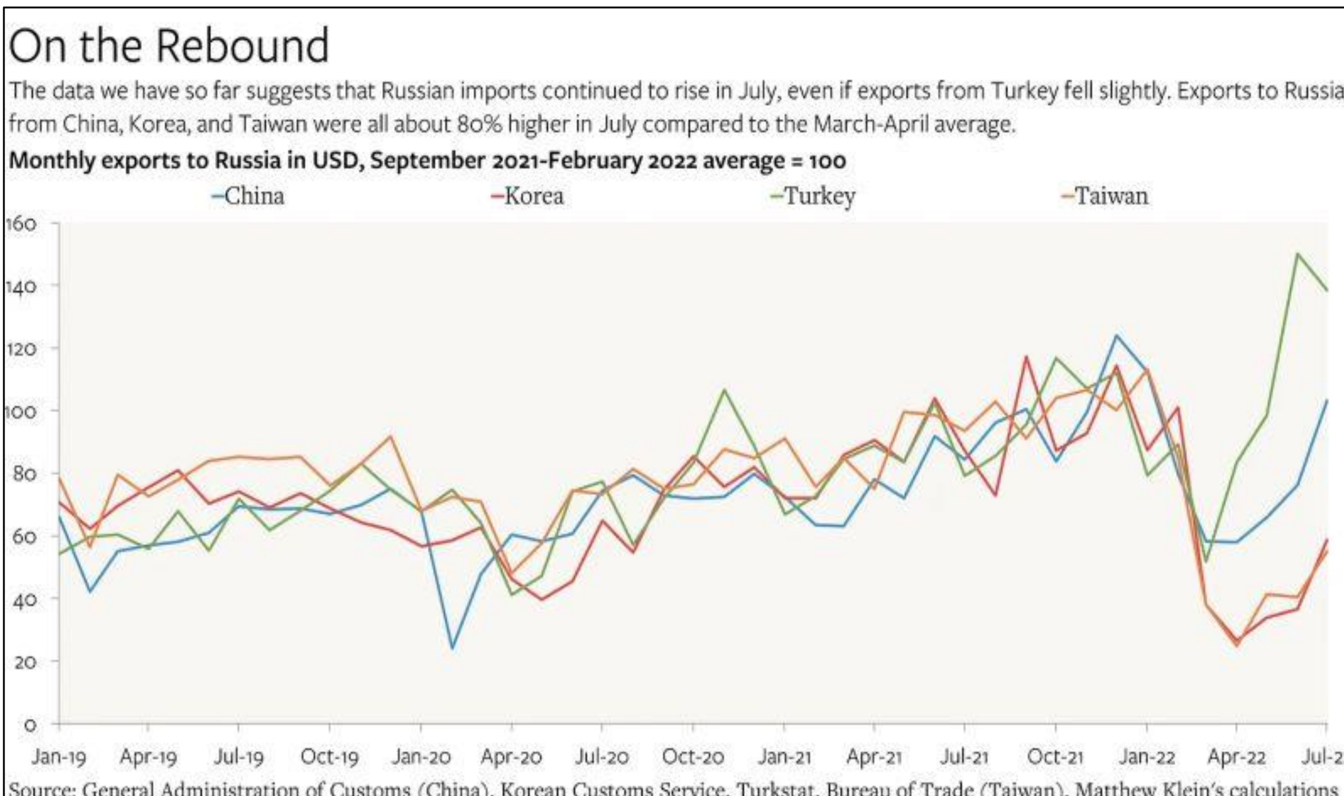
Germany is unfortunately sick again now. It's growth model was heavily predicated on cheap Russian energy. That's over..

The data flipped again - Some bad economic data from China out earlier. With China's six-month credit impulse turning negative again in July, the activity data may continue to disappoint.

Charts that Matter!



Profitless growth - US profits indicate they are already on verge of declining (ex-energy) and hence the recession inducing downward pressure on business inventories has now only just begun.



The Squeeze on Russia Is Loosening - Exports to Russia from the major manufacturing economies have been rising rapidly since April. If the US + allies do not act swiftly to tighten the enforcement of sanctions and export controls, the Russian military may be able to replenish its losses of equipment and advanced ammunition and prolong the war. (Source: Matt Klein)

Why are we afraid of QT? - Fed has never been able to successfully implement QT without breaking something. They have always reversed their policies and instead embarked on a new QE. Why will it be different this time?