Albert Edwards: The Ice Age Is Finally Over

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The US is likely headed into a proper recession, but according to one erstwhile deflationist, the "secular theme of lower lows and lower highs in Fed Funds and bond yields has been broken in this cycle."

That, you'll immediately note, sounds like a recipe for stagflation.

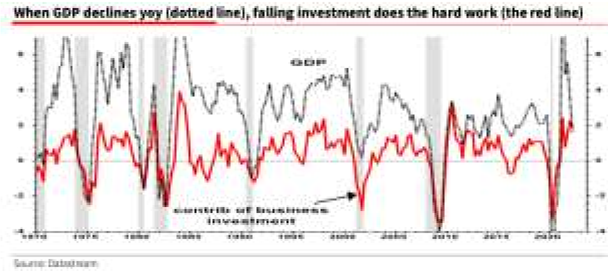
According to SocGen's Albert Edwards, an oncoming downturn in the US will "bring temporary cyclical relief to the secular tightening cycle," as the combination of recession and an energy-driven decline in headline inflation gives the Fed plausible deniability to cut rates despite stubborn core inflation, which he said could remain "well above target."

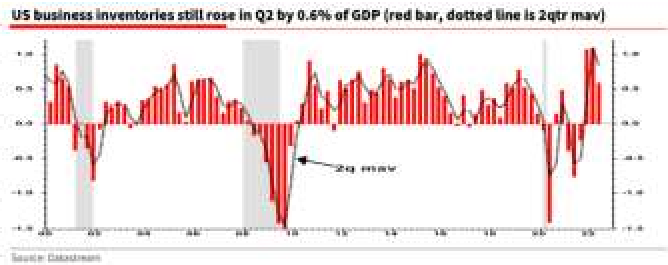
In the US, corporates, still shellshocked by the acute labor shortage that defined the post-pandemic macro environment, will hoard workers headed into the recession, which means that although consumption will "hold up better" during the downturn, profits will "strain and collapse as labor becomes more of a fixed cost."

Earlier this week, Walmart CEO Doug McMillon told CNBC that in his view, "wage inflation is going to be with us forever," and because "pricing has to be adjusted to reflect" that reality, "there's some level of inflation that's going to be with us basically forever" as well.

Edwards said this is "key" to the depth of any coming downturn. Recessions, he wrote, are typically the result of large oscillations in the business investment cycle "as companies react to both falling profits and margins."

Usually, business investment (so, fixed investment and inventories) chips in 1-2 percentage points to annual GDP growth. In recessions, though, declining business investment drags the economy into the abyss. "Where the dotted line falls to or below zero, the red line totally overlays it," Edwards wrote Thursday, referencing the figure on the left (below). "In an accounting sense the recession is entirely 'caused' by business investment."





SocGen

He went on to say that America's inventory problem (underlined again this week by retailers reporting Q2 results, with Target as the poster child) is the next shoe to drop.

Although Q2 earnings season was generally better than expected in the US, energy did quite a bit of the heavy lifting. Edwards cited colleague Andrew Lapthorne in noting that excluding energy, profit growth is perilously close to turning negative.

That's the recession thesis. The short version anyway. But notwithstanding the downturn and any associated decline in yields and policy rates, Edwards said the "Ice Age" (his long-running macro framework) is at an end. He mentioned remarks from Bridgewater CIO Bob Prince.

"I agree with Prince that we have now entered a multi-year tightening cycle," Edwards said, before noting that in his view, "we are set for a very lengthy secular rise in rates and that despite a collapse in headline inflation in the coming recession, core inflation will likely rise through many cycles rather than be tamed." It won't be one tightening cycle "and done," Albert said. "There is much more to come."

In "Transitioning to Stagflation," Prince wrote that "As central banks pursue their dual mandate of maximum employment and stable prices, they will not be able to achieve both at the same time and will be forced to choose between too-low growth in order to achieve their desired inflation rate, or too-high inflation in order to achieve their desired employment conditions."

That, Prince suggested, will result in erratic policy (he didn't use the word "erratic.") "In managing through this, we see them toggling back and forth in their prioritization, trying to avoid both an unacceptably deep economic contraction and an unacceptably high inflation rate, culminating in a long period of too-high inflation and too-low growth," he said.

In other words: Stagflation.