Inflation, Bonds & Insanity

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![Macro Intelligence 2 Partners logo]

Inflation: The Key Variable in 2021

5th January 2021

Summary

- Bond markets are being kept in check by central banks concerned by low inflation
- But as we move into 2021, especially in Q2, prices are set to rise significantly globally
- The drivers are the dollar, commodities, transportation, and possibly more fiscal spending
- How policymakers ultimately respond is the key variable for markets in 2021 and beyond

At the depths of the Covid-induced market swoon, we sent you a piece suggesting you buy inflation breakevens and more recently, re-enter the trade ("MI2 Trader: Momentum Breakout" 2nd Dec). However, our focus on rising prices goes well beyond one-off trades. Since early 2016, we've believed that numerous factors, especially in the US but also globally, suggested the inflationary cycle was basing. Some of these were market-induced ("History Repeats: Oil and Inflation" 1st March 2016). Others reflected the increasing prominence of fiscal policy. For example, Trump's procyclical splurge reminded us of President Johnson's spending in the late 1960s ("Oscillation of Inflation" 18th Jan 2017). More recently, this past summer, we became concerned about a manufacturing-induced inflation burst ("Inventory Cycle and Inflation" 22nd June). Since then, the broad narrative has become much more mainstream. However, that doesn't mean you can take your eye off the ball. In fact, we believe inflation (and especially how the Fed respond to its resurgence) is perhaps the key issue for 2021.

As we have discussed, when it comes to market price action, bonds stand out like the proverbial sore thumb ("Thoughts from the Virtual Road" 23rd Nov). Some pundits put this down to the sheer volume of central bank buying. However, as we have discussed, because QE is fundamentally reflationary, it is highly unusual to see yields fall, as the balance sheet has expanded. Indeed, the only other time this occurred was in late 2008.

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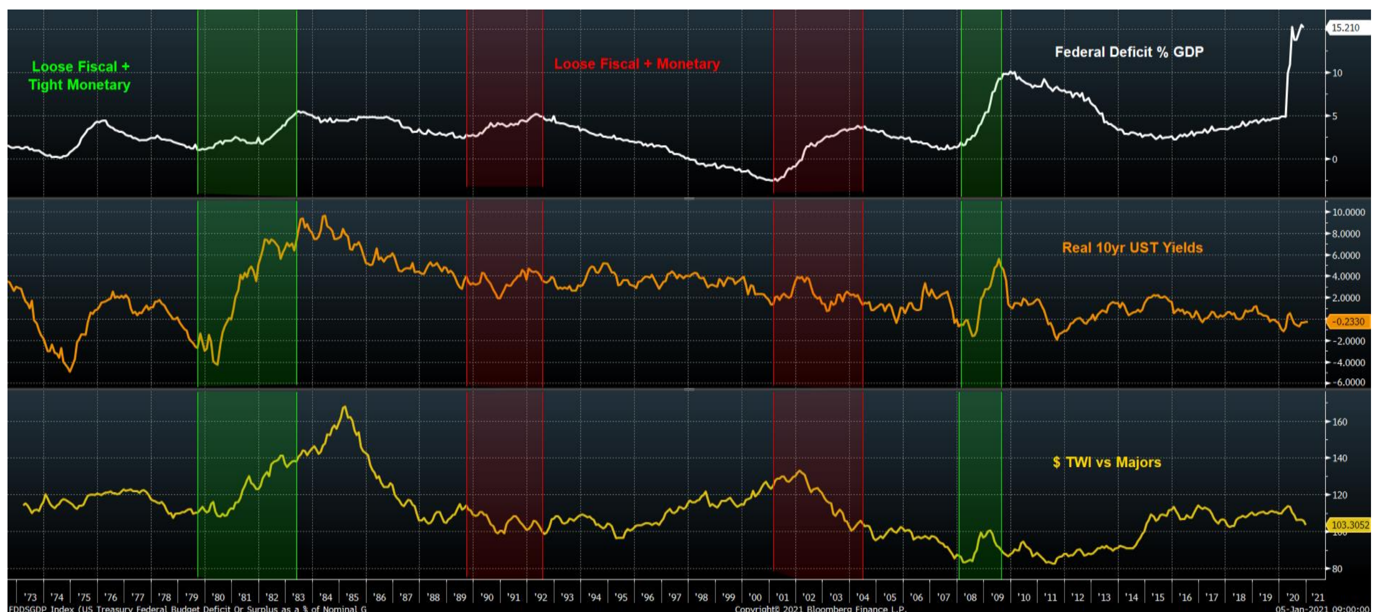
In part, we believe this inertia in bonds can be justified by low CPI prints. Then there is the policy shift towards things like average rate targeting, which implies central bankers will initially accommodate higher inflation and, by keeping the front end nailed to the floor, hold most of the yield curve in check. At least for a while. However, if you follow the logic to its natural conclusion, once inflation has become ingrained, the monetary authorities will have to buckle. Remember the phrase "getting behind the curve"? At some point, the odds are that we will re-run the 2016 experience: when CPI spikes, yields inevitably follow.

If indeed that's how 2021 pans out, then, as we discussed in our Virtual Roadshow, markets will look very different. In particular, with likely ongoing fiscal deficits in the US, if the Fed allows real yields to rise, then we'd be looking at a policy mix of loose fiscal and tight monetary policy. Historically, this is extremely dollar bullish, so would be highly deflationary for the rest of the world with profound implications for EM, commodities etc. Given the current political and economic backdrop, we think this is unconscionable, which is why we believe the Fed will be forced to move to ultimately embrace implicit or explicit YCC. Given a natural reluctance to take such an enormous step, we'd bet the transition isn't smooth. A bit of pain will be required to drag the FOMC over the cliff, which is why it's so important to understand the dynamics and timing of any inflationary pressure.



Let's start with FX. As any student of history can attest, whether you look at inter-war Germany or Zimbabwe after 2007, currency weakness and inflation tend to go hand in hand. However, some may be surprised to discover just how tight the correlation between the two can be. For example, below it is clear how directional changes in the dollar's value lead broad CPI by about 6 months. Note how from 2016 to mid-2018, a rapid collapse in the YoY rate of change in USD strength was sufficient to help drive CPI from zero to 3%, even though in absolute terms it was unchanged. This

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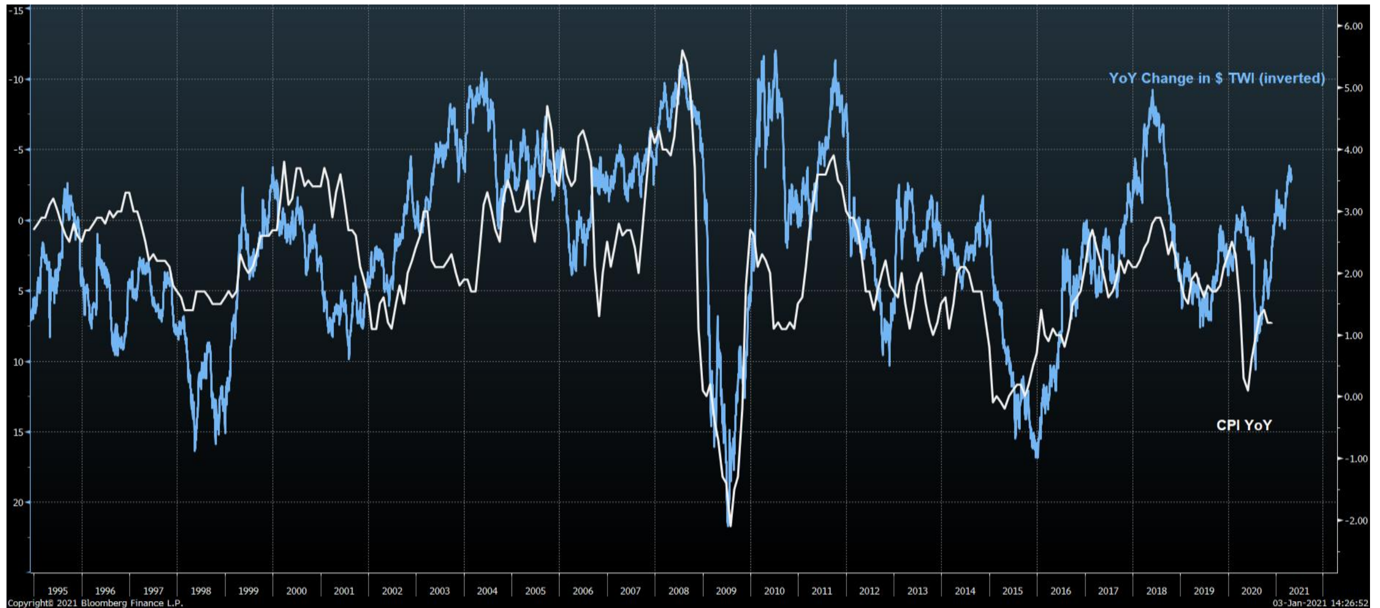
time, on a TWI basis, the dollar is down just over 12% and the base effects won't hit a peak until Q2. This alone will drive CPI considerably higher in H1 2021.



Interestingly, while it's tempting to suggest dollar weakness will push deflationary pressures elsewhere, the data suggest that's not true. For example, note how the dollar has also led G7 CPI.

Some of this is of course a function of commodity prices, which, being dollar-denominated, tend to rise when the dollar is weak but also when we have broad-based global growth. This is perfectly captured in the chart we first used in 2016 and shows the boom-bust nature of the oil price cycle. As you can see, in mid-2020 crude prices were down 75% YoY, which far exceeded the extreme

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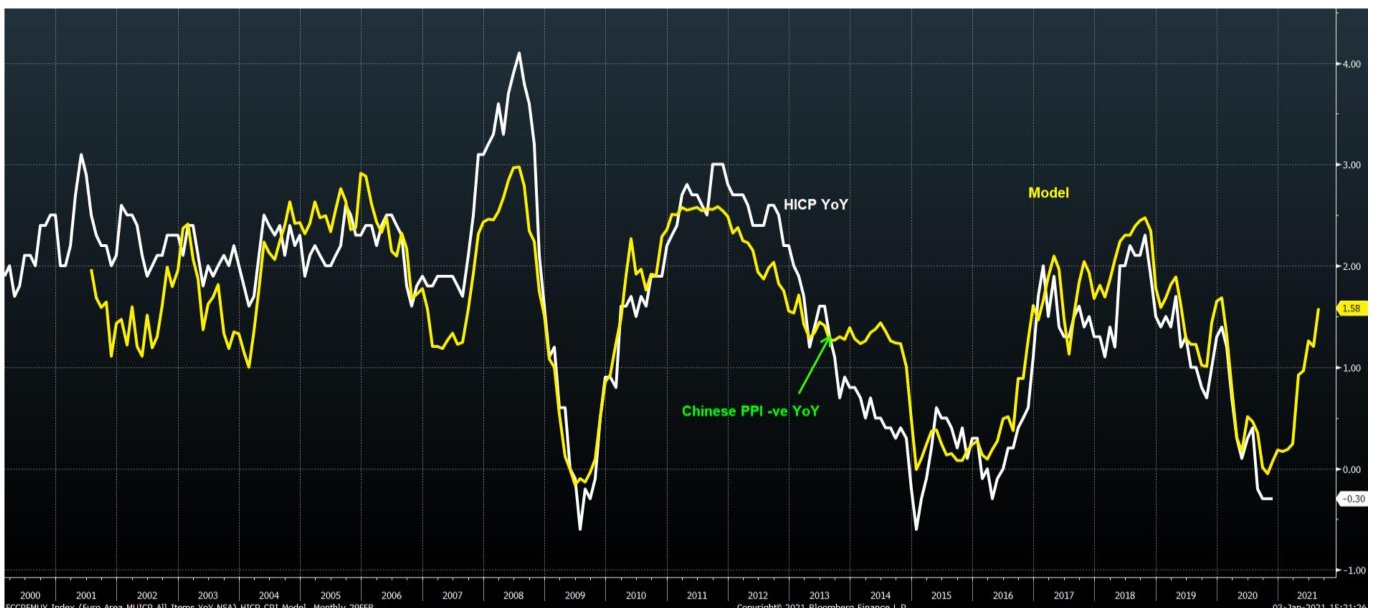
45-60% drops of the last 40 years. However, the key point is that in the past these declines were always followed by accelerations of at least 80%. That's key when it comes to inflation because it's the rate of the change in the price of crude not the level that counts. And given last spring's oil collapse, unless something radically changes, the base effects in Q2 2021 will be enormous. This factor alone should easily support a significant spike in headline inflation.

By way of illustration, one of our models, which has worked brilliantly and almost exclusively uses commodity prices, suggests that starting in Q2, Eurozone HICP will jump 100bps. P.S. This is one reason we believe the ECB will accept EURUSD moving higher.



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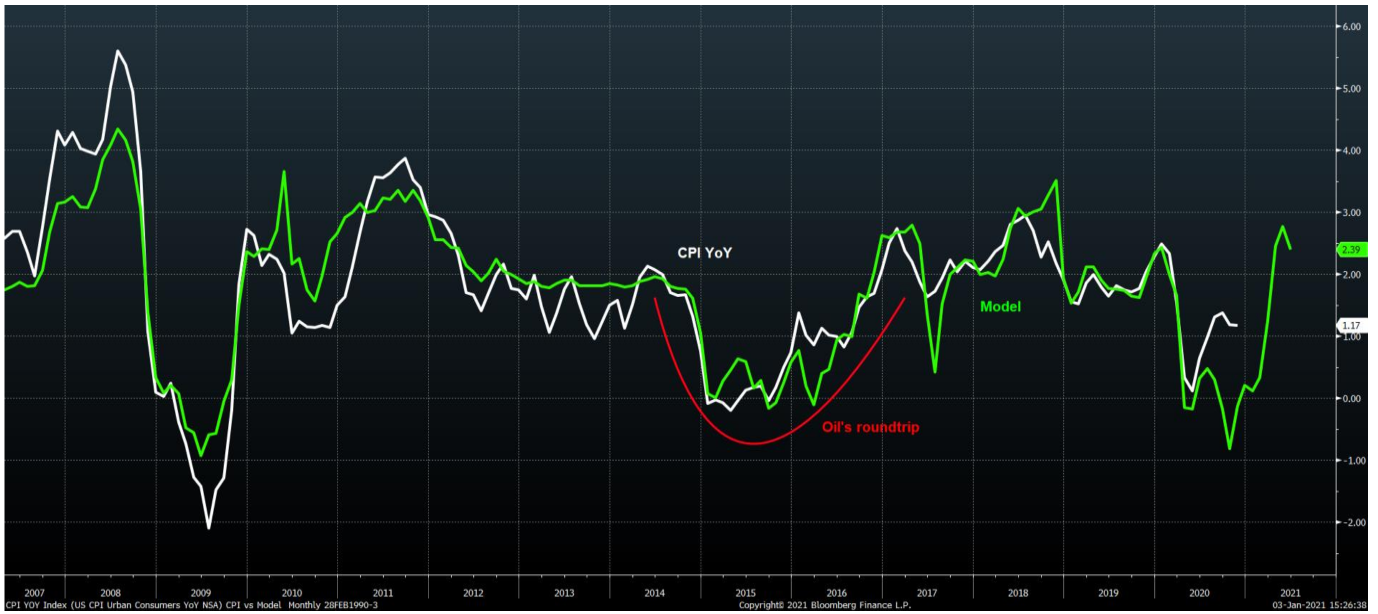
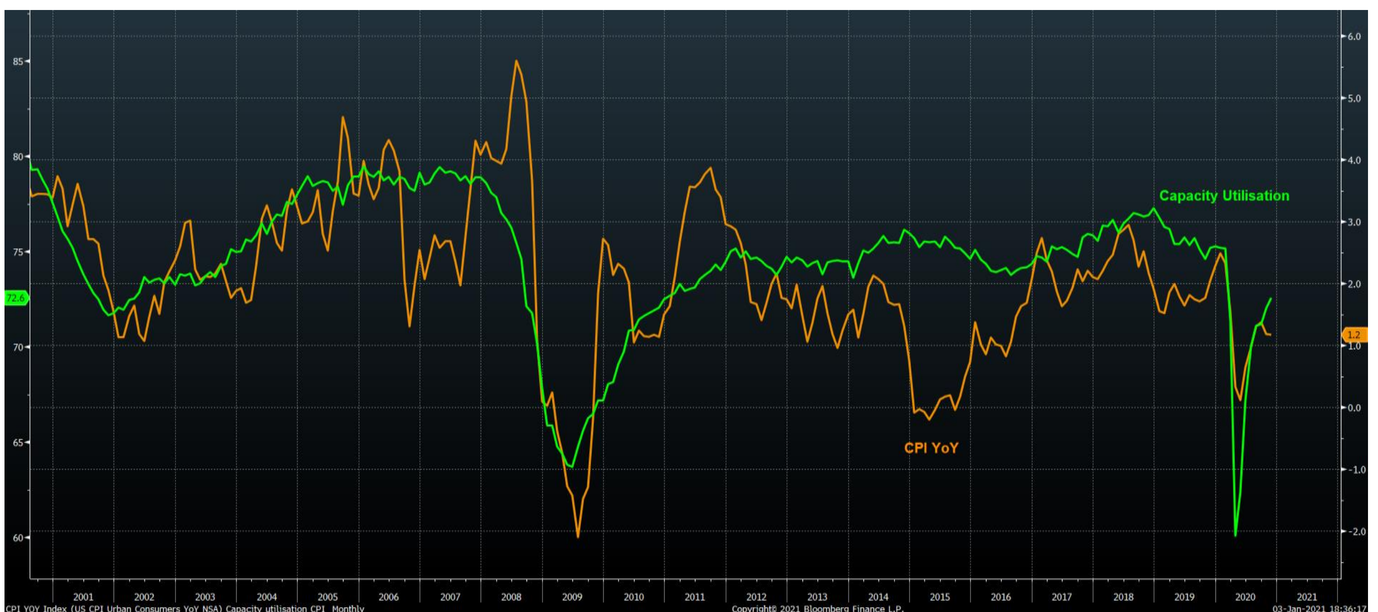
Interestingly the equivalent US model hasn't worked so well, because the big drop in CPI it predicted into yearend hasn't occurred. The end result is that it will start from a higher level as it spikes in Q2. The order of magnitude could be very significant with CPI hitting 2.85% by the end of Q3 before falling back as base effects wane.



That brings us to the next big topic, cost-push inflation. This phenomenon is a standard feature of the broad business cycle, as it tends to wax and wane with capacity utilisation. Therefore, as the global economy has snapped back, some pricing power was inevitable.



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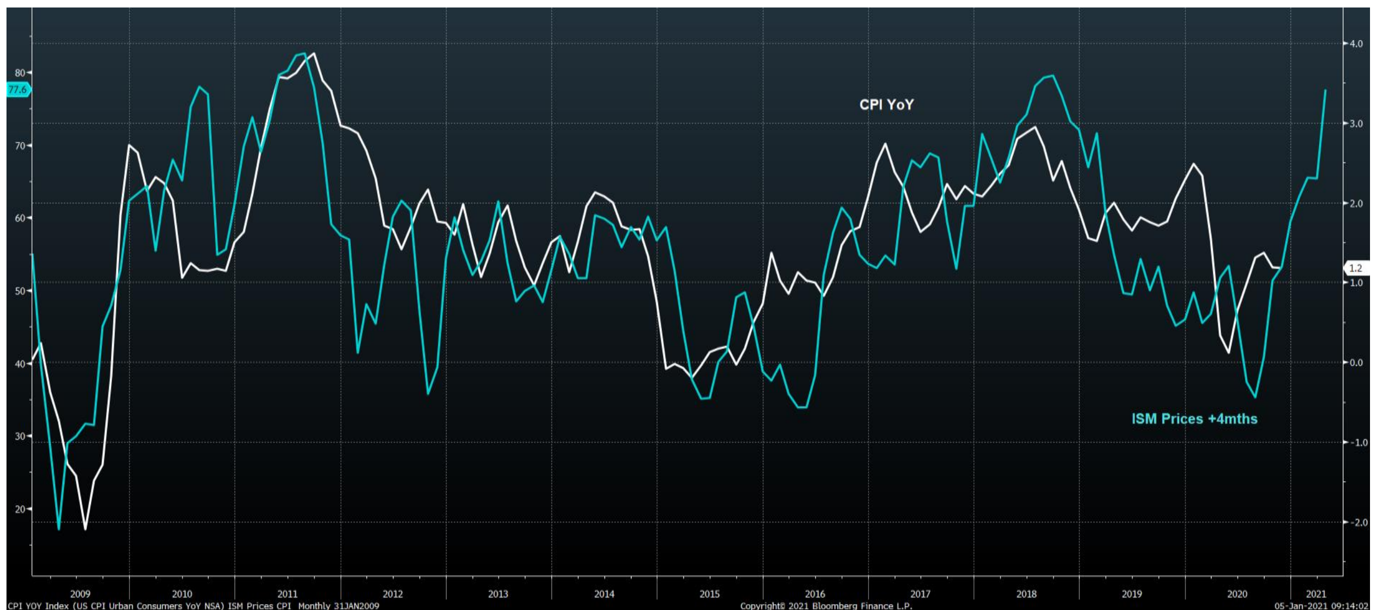
However, what is surprising is that even though Covid has destroyed demand in whole swathes of the economy, cost-push inflation is showing up so powerfully. For example, just look at how in today's ISM Manufacturing Index, the price component exploded. While it isn't a perfect proxy for CPI, it does suggest sharply higher prices. In 2018, this level of the indexes helped deliver almost 3% CPI YoY.



Aside from commodity prices, the other area driving company costs higher is transportation. This was perfectly captured in this week's Markit US Manufacturing PMI, which noted how manufacturers are *"seeing COVID-19 disrupt supply chains further, causing shipping delays. These delays are limiting production capabilities as well as driving producers' input prices sharply higher. Firms were able to partially pass on higher costs, however, as selling prices increased at the sharpest rate since May 2011".*

Our model, which uses transport costs is picking this up. Interestingly, it suggests that the impact won't just be contained to headline inflation but rather manifest itself via higher core CPI as we move into the second half of 2021.

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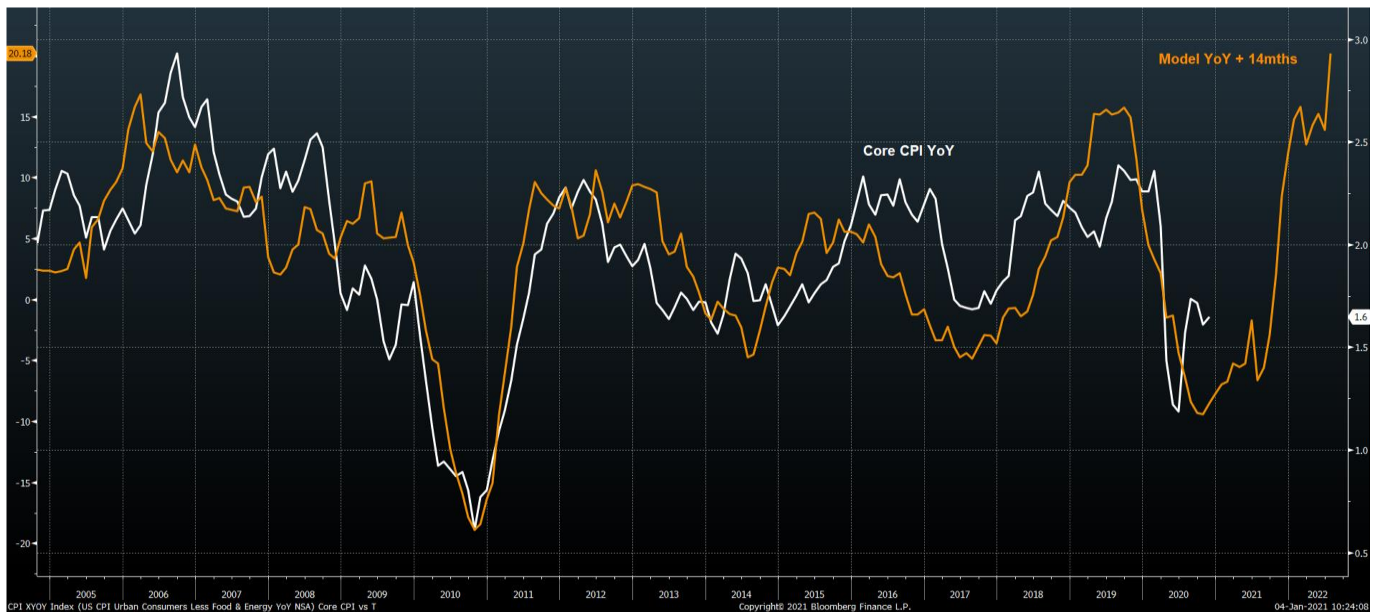

Clearly, at some point bottlenecks should be addressed and together with waning base effects in Q3, it will be tempting to believe prices have peaked. We are pretty sure this will be the line the Fed will adopt to bolster their spin that inflation increases are simply "transitory". One area that they'll almost certainly be able to point to is wages, because typically we don't see rapid wage growth (i.e. over 3%) until unemployment falls to within 0.3% of NAIRU. Currently, we are miles from that level and, given our view on the slow recovery in employment, unlikely to get there this year ("Employment: Run It Hot Baby" 3rd Dec).

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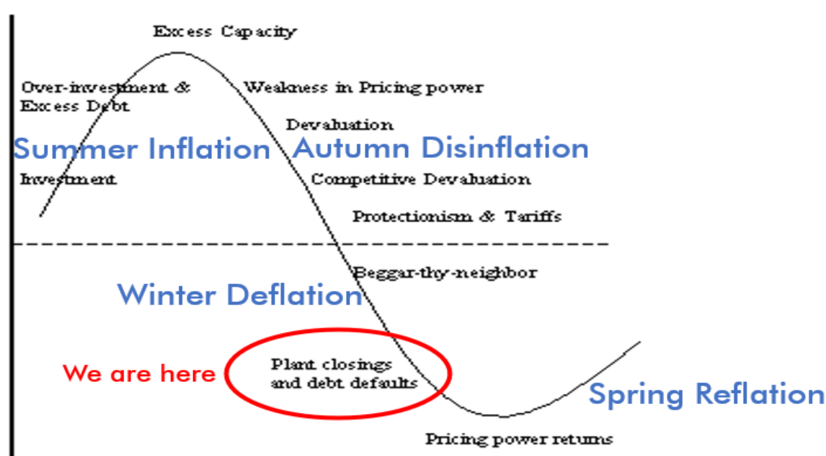
Another key area that commentators have suggested will weigh on inflation is Owner Equivalent Rent. However, interestingly, our models suggest that it will be stable rather than the significant drag implied by extrapolating the current downward trend in the YoY rate.

That brings us to a couple of structural observations. Since the GFC, easy central bank financing has prevented the collapse of various industries, in the process creating swathes of "zombies". Yet, thanks to CV-19, we are finally seeing some bankruptcy, rationalisation, and capacity reductions. We are hopeful that this marks the beginning of a new stage in the cycle, which will see a return to pricing power.



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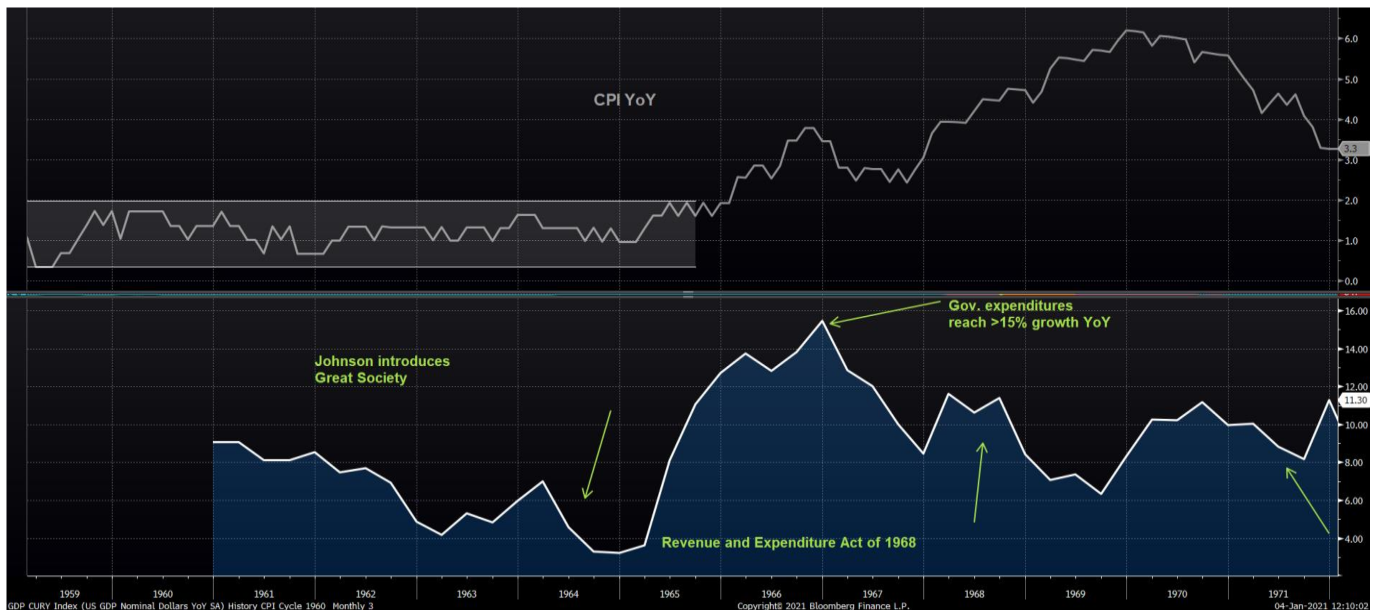
Once again this reminds us of the late 1960s. The outcome of the Georgia elections is perhaps the next big step along this path. If the Dems win control of the Senate, the odds of a massive infrastructure bill will rise. This will support aggregate demand beyond its natural cycle, which in turn raises the risk that just as inflation should naturally peak, it will be underpinned by a surge of fiscal spending, as was the case from 1968-70.



It is also worth remembering that, while inflation expectations are currently stable, one of the lessons of the 60s was that that should not be taken for granted. This risk is echoed in the Fed's own work ("Non-Linear Phillips Curves with Inflation Regime-Switching" – sounds riveting doesn't it?), which suggests that just two years of core PCE price increases of 3%+ may have been sufficient to permanently "unanchored" inflation expectations. Whereby, expectations and behaviour adapt to higher prices. Past inflation then causally drives future prices and most importantly becomes additive, carrying over from cycle to cycle. Essentially the "Oscillation of Inflation", which we first flagged almost exactly four years ago, becomes engrained.

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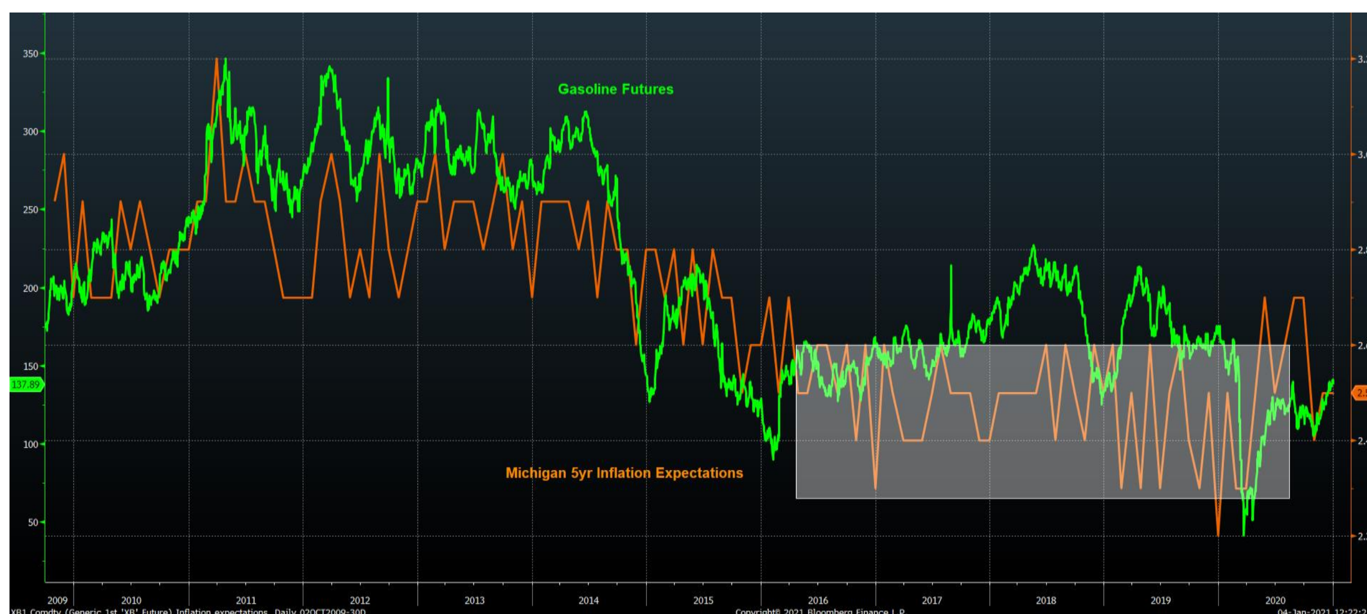

At that point, the Fed would have to take a stand. But two years is an eternity, for traders and policymakers alike. In the interim, we expect them to prevaricate and spin because that's what is currently expedient. Therefore, for us, the bet is higher headline CPI, which rises sharply into Q3. What happens at that point will depend heavily on on-going fiscal support to the global economy, the fate of the dollar and the extent of creative destruction ultimately wrought by Covid.

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Bonds: You're Only Supposed to Blow the Bloody Doors Off!

9th February 2021

Summary

- **The market is expecting higher inflation, but we fear their estimates are still too low**
- **The size of Biden's stimulus package is so large that even the fiscal doves are worried**
- **The Fed is utilising a crawling yield peg, but the risks of a 1987 or 2016 spike are rising**
- **Perhaps they can hold real rates stable, but even higher nominal yields are a risk**

One of the inimitable lines in British cinema is from the original Italian Job. When practising for a bullion heist, Michael Caine asks one of his team to place a small charge to blow the lock on a truck, only to see the whole vehicle explode! Well, when we look at the degree of fiscal and monetary stimulus being fed into the US (and frankly even the global economy), we can't help but think this is the risk.

One area of concern is inflation, and we have been clear that we believe it is heading a LOT higher. Indeed, together with how the Fed responds, we view it as the key variable in 2021. Add to that mix the Biden Administration's planned fiscal spending and you have a potentially toxic nominal GDP backdrop for fixed income. Thus far, bond markets have been happy to act as the proverbial frog. Yet, we worry that this isn't the first time that fixed income has been slow to react, and we are struck by the similarities to the setup in late 2016, just before 10yr Treasury yields spiked 90bps.

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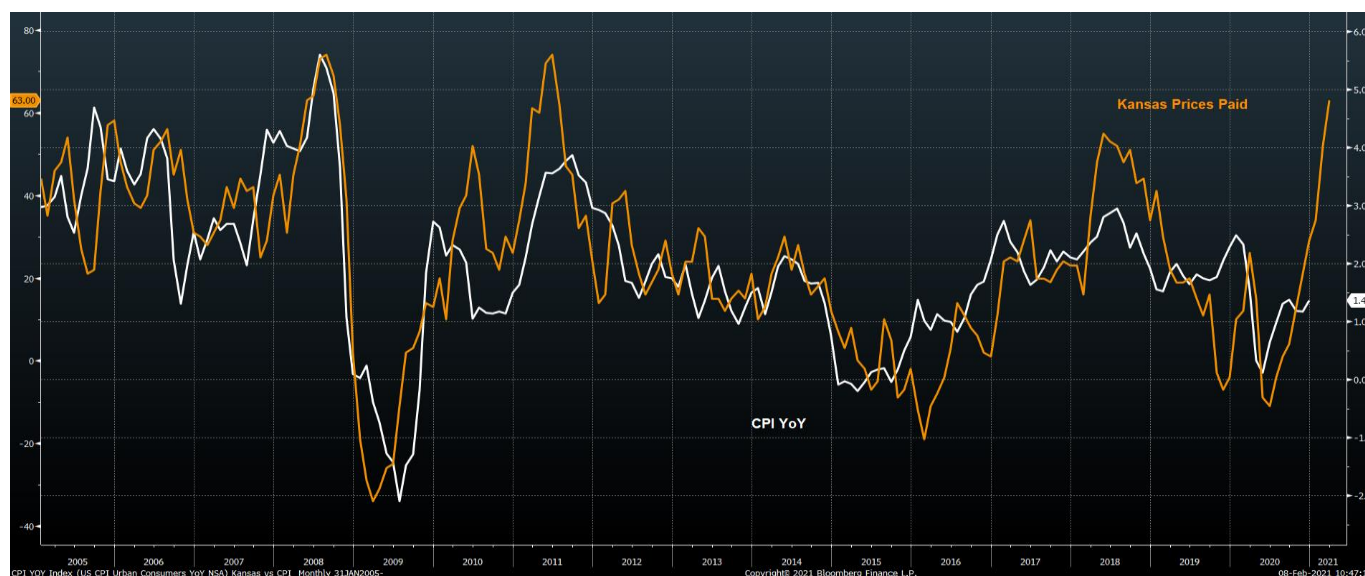
We have discussed inflation in numerous pieces and don't wish to labour the point. But the numbers are utterly relentless, and the anecdotes keep building. For example…

US Markit Manufacturing PMI: *"The rapid increase in cost burdens reportedly led many firms to partially pass on higher input prices to clients. Amid favourable demand conditions, companies registered the sharpest increase in output charges since July 2008" ….* P.S. Back then CPI was 5.6%

JPM Global Manufacturing PMI *"Disruptions and resulting shortages contributed to an uptick in purchase price inflation, which was passed on to clients through higher output charges. Input price inflation was the strongest since May 2011* (CPI 3.6%)*, and charge inflation the joint-highest over the same period."*

Visually, this is perfectly captured by the Kansas City Fed Prices Paid Index. The point is that while markets are expecting higher inflation, we worry they are still dramatically underestimating the scale and immediacy of the threat. For example, we have CPI on Wednesday, and even though the last PCE data was far higher, expectations are for a modest 0.1% YoY rise in the headline and a slight decline in the core. Month to month data is always a little bit of a crapshoot, but for us, the risks are clearly to the topside.



That brings us to fiscal spending, especially here in the US. Last spring, we sent you a video entitled "The Inflection Point is Now" (17th Apr). It explained how CV-19 had accelerated us towards a natural societal tipping point, and, based upon precedent, we should expect the rise of big government. In that sense, Biden's victory, with its focus on equality and fairness, is simply a manifestation of the cycle of history. As we have discussed, this is comparable to the late 1960s, with Johnson's Great Society and Vietnam War spending, which was a period that, despite a pegged dollar and controlled prices in everything from shipping to oil, saw inflation quadruple in under five years!

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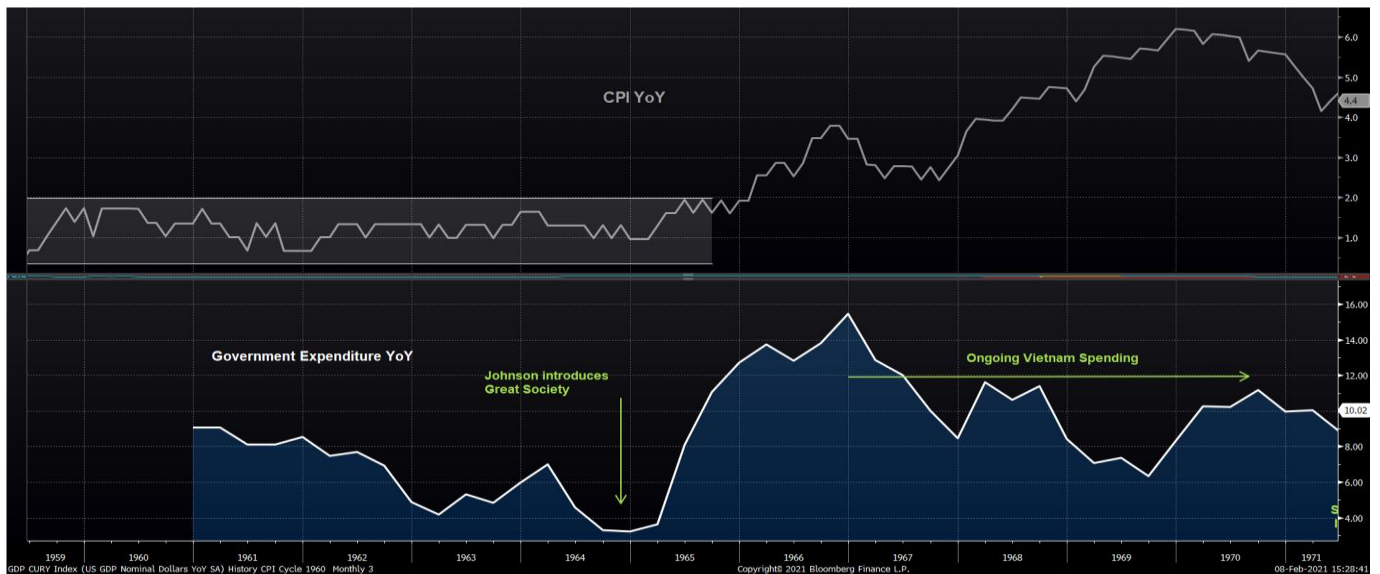

Historical comparisons aside, the reality is that Biden's spending plans are enormous, and odds remain that the next stimulus is far closer to the proposed $1.9tln than markets currently expect. Right now, there seem to be only two views among DC politicians; those in favour of a massive expansion in fiscal stimulus and those who want to do more. Indeed, when previous enablers of spending like Larry Summers or Blanchard start to get worried about overcooking it, you should too ("Debt/GDP: The Infinite Horizon" 9th Dec 2020)!

Olivier Blanchard @ojblanchard1 · Feb 6

Let me double down and go through some numbers. I agree that too much is better than too little and we should aim for some overheating. The question is how much. Much too much is both possible and harmful. I think this package is too much.

73 400 836

Olivier Blanchard @ojblanchard1 · Feb 6

CARES added 900 billion of stimulus in December. The Biden proposal adds 1.9 trillion. The infrastructure program to come, will add more, but let's leave it aside. Adding the three numbers above gives: 3.6 trillion or 4 times the upper bound on the output gap.

5 15 58

By the way, Blanchard is right to be sensitive to this. As the output gap closes, inflation typically rises, and the nominal GDP outcomes we are potentially talking about could see the gap close quickly, especially when permanently lost capacity / de-globalisation is taken into account.

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That brings us to the 2016 analogy. If you cast your mind back, late 2015 saw the Fed turn hawkish, and China devalue the CNY, which sent assets markets into a tizzy. The result was that when policymakers met in Davos in January 2016, they unleashed an almost unprecedented wave of co-ordinated intervention and risk assets ripped as the reflation meme gripped the market.

However, by that summer, in a report entitled "What Markets Should Fear is Strength Not Weakness" (7th July 2016), we wrote:

"It would seem to be an odd time to suggest that as we move into the summer and you have time to work on your tan, the biggest tail risk you need to consider in the second half of the year isn't continued economic weakness but in fact renewed strength in both growth and inflation."

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We explained that the reflationary wave triggered by policymakers' rapid response was carrying the inevitability of inflation in its wake. Furthermore, the flip from hiking to easing had caused the Fed to question their faith in their forecasts. As a result, they had moved to a more reactive, data-dependent mode rather than a proactive stance. At the time, we wrote,

"Essentially, they are trying to drive the car while looking through the rear-view mirror. Now that's fine in theory but what if they are wrong not just about inflation but also growth?"

This set us up bond investors for a fall, i.e. when they assume policymakers have their back only to wake up and find those very same officials change direction in response to the data. Our conclusion was,

"Yet, as we look at continued easing from central banks and fiscal authorities, we can't help but think that they are fighting the last war. Yes, we understand that growth and inflation are ultimately the end game. But with pricing in global bond markets at extremes and dependent on a precise set of circumstances to maintain the current yield feeding-frenzy and flow of funds into fixed income, a policy error at this point would be highly costly."

As it turned out, our concern was warranted. Yields rose steadily through the summer only to exploded late in the year as CPI started to accelerate and Trump's election raised the prospects of loose fiscal policy.

Fast forward to today, and like any good analogy, the comparisons aren't perfect. By the way, back in 2016, the rhyme we were using was 1987, when bond yields rose 300bps rapidly. But in both scenarios, markets leant too heavily on Fed officials' platitudes, only to find out that they had misread the data. We can see the same happening again. This time, we expect officials will initially dismiss any price spike as "transitory". But will a data-dependent Powell Fed be able to hold the line if Goldman's forecast of 6% real GDP and our headline 3% CPI is right?

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There is also an element of whack-a-mole. It's a big yield curve, so can the Fed control the whole thing? For example, in 2016 not only did the long end blow, but Eurodollars also dropped precipitously. Is 9% nominal GDP growth later this year compatible with no rate hikes until 2023? Yesterday, Goldman moved their forecast for the first hike to the first half of 2024, and they only expect a stimulus of $1.5tln.

P.S. If we use the 5-, 20- and 50-week moving averages we use for the S&P, they also work quite nicely for Eurodollars. As in 2016, plus other notable occasions when they caught the moves, they have once again crossed to the downside. Watch a break of the prior lows at 99.38.

However, even assuming they can hold the front end, they aren't going to prevent breakevens from moving higher. Since last March, this has been our favourite bond trade, and we recommended it again at the end of last year ("MI2 Trader: Momentum Breakout" 2nd Dec 2020). Our model currently suggests that 5yr should move to another 70bps towards 3%!

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What's more, the more they do resist, the greater the pressure they are building. Note how, even before a further move, the spread between 5yr conventional Treasuries and Breakevens is already more extreme than it was heading into the taper tantrum.

The result is that, outside breakevens, the long end is likely to remain under pressure. Note how 5-30's broke, retested, and is now accelerating from a lovely channel. This suggests that 1.9-2.05% is the initial target and even something as crazy as 2.9% would be possible if the Fed holds the line and we move the full width of the channel.

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That brings us to the big question: will the move the be gradual or (as in 2016 and even 1987) are we on the cusp of a rapid lurch that would clearly be a far bigger threat to other markets? At present, our sense is that by clustering their buying to prevent an accelerative spike in yields, the Fed is trying to let the air out of the bubble gradually, essentially trying to maintain an orderly ascent in yields with an implicit YCC crawling peg.

So far, so good, and drawing down the Treasury General Account will also help via reduced issuance. Indeed, perhaps this combination of tactics can be used to massage a move higher, especially in real yields, even as inflation moves higher. As we have discussed, real yields and relative nominal yields will be pivotal in deciding the dollar's fate and by inference all markets ("Inflation: The Key Variable in 2021" 5th Jan). Indeed, it is worth noting that both JGBs and Bunds

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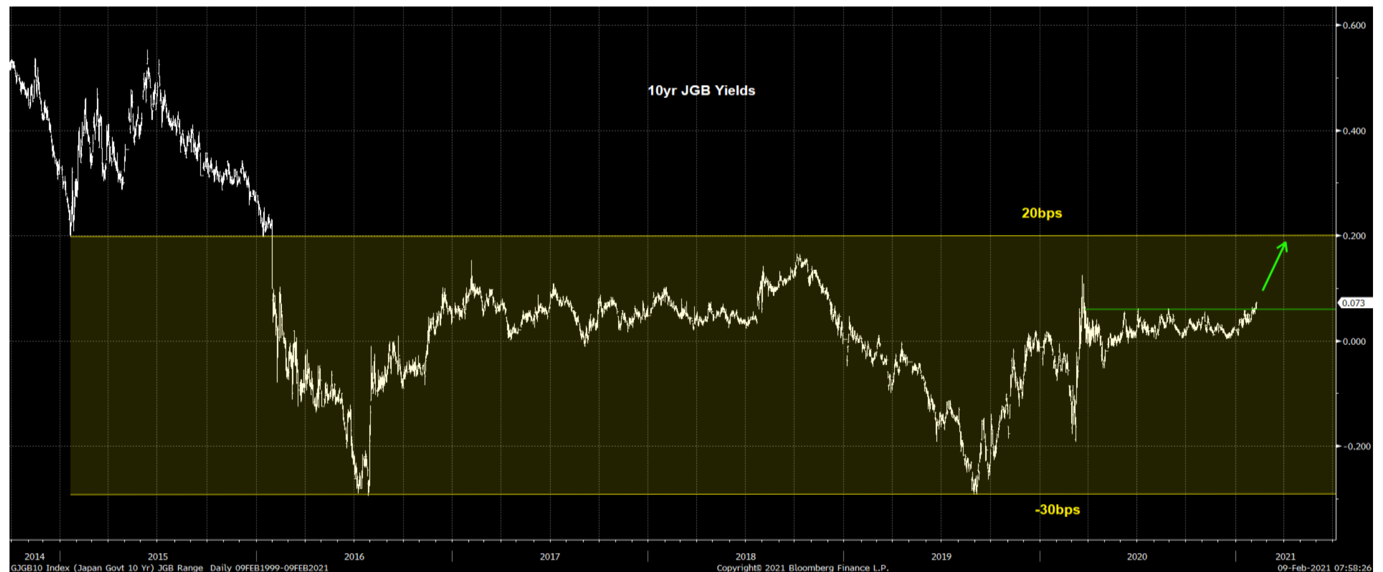
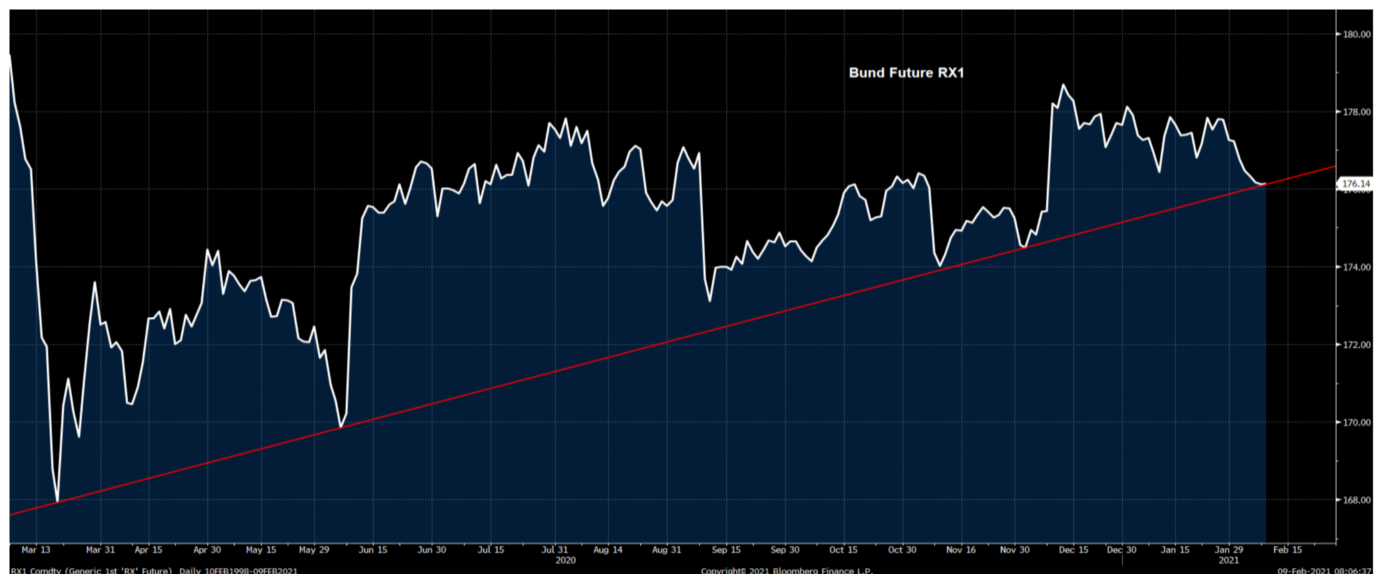
are also looking interesting for the first time since Covid. P.S. These moves are almost certainly why the dollar hasn’t responded to higher Treasury yields.





However, a “crawling peg” for yields and even low real rates isn’t the same as no move higher in yields at all. Indeed, as we flagged, assets like gold are as expensive as they ever get and could be in trouble, even if the move is limited to nominal rates (“Opportunity, Threats, and Instability” 19th Jan). Furthermore, as discussed in the same report, we worry about the mega-cap, momentum names with their super high P/Es that dominate the US market. At some point, even if real rates remain contained, won’t they notice that their discount factor has tripled or more? On that note, we would point out that since we plugged that 10yr dollar swap rates were breaking their trendline, they have steadily marched higher (“Chart Point: US Yields at Key Levels” 3rd Nov 2020). Their

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natural target would be 1.35-1.5%. But we are cognisant of the lessons of 1987 and 2016. Therefore, while the Fed doesn't mean to mislead markets or want things to get out of hand, the reality for markets is that if a central bank is data-dependent, then it is dangerous to rely too heavily on their promises. Accidents happen, and driven by inflation and growth, we could easily see rates test 1.9%. At that point, discount rates will have quadrupled, Treasury yields would be 50bps above the S&P dividend yield and the bank robbers' truck may well have been vapourised!

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The Fed's Balance Sheet: The Definition of Insanity

17th August 2021

Summary

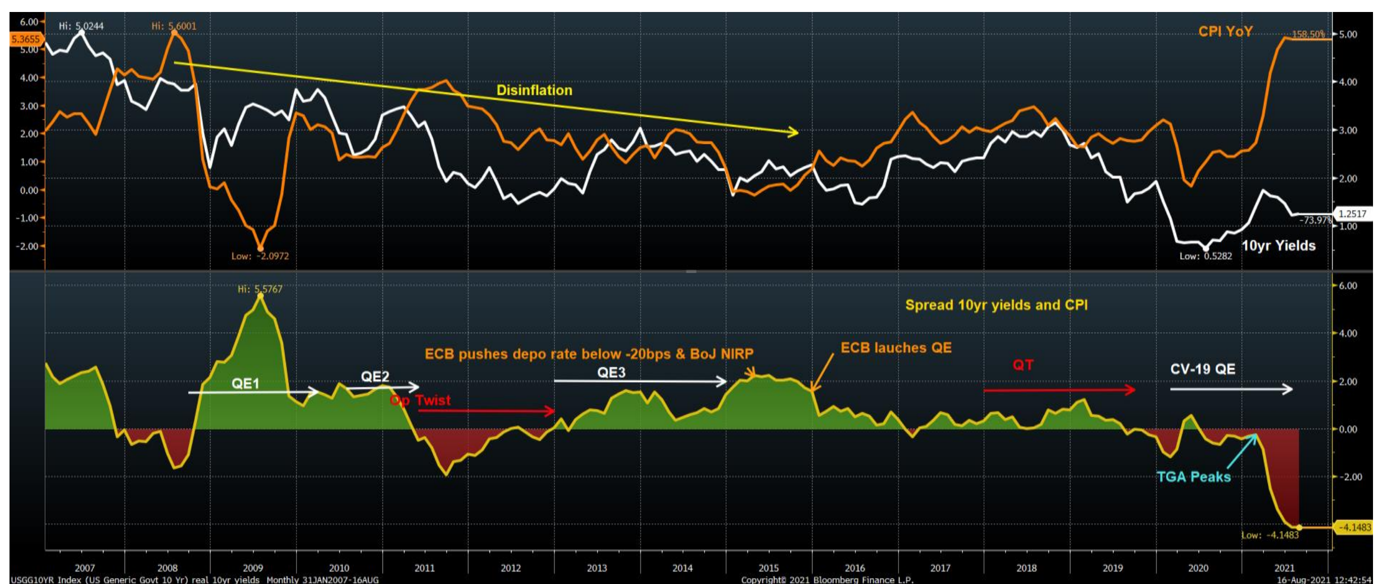
- We believe that the balance sheet is just too powerful a weapon to be withdrawn
- This is because markets believe QE is reflationary, i.e., it drives higher equities and yields
- Hence, as in the last two tightening cycles, any tightening is ultimately doomed to fail
- Currently, we are less concerned about a dollar Napalm run but worry about equity markets

After Friday's blowout NFP report, talk of tapering has naturally accelerated, suggesting that it is yet again time to ask, "Can the Fed Successfully Shrink the Balance Sheet?". We first raised this question back in April 2017, and back then, our answer was an emphatic NO. This answer was ultimately borne out by a surging dollar, sharp equity correction and eventually, in early 2019, Powell's ignominious policy reversal. So, will it be different this time?

Ahead of the last tightening cycle, the main reason we were so convinced that QT was doomed to failure was that our work suggested that the balance sheet is a far more powerful weapon than commonly understood. At the time, this was in marked contrast to Fed officials, who maintained it was fungible with interest rates.

> *"We estimate the impact on the whole structure of interest rates from $600 billion is roughly equivalent to a 75bp cut"* Bernanke 2011

Their argument presumed that both tools reduced bond yields and, in fairness, there were periods when that appeared to be the case. For example, from the start of QE1 in 2008 until the end of QE3 in 2014, 10yr yields fell from 3.75% to 1.6%. Unfortunately, CPI also collapsed during that period, and we believe it, rather than QE, was the main driver of lower bond yields. In fact, through QE1, 2 and 3, real 10yr Treasury yields were pretty stable. Indeed, right up until the $1tln run-down of the Treasury General Account, the same was true in the most recent bout of QE.



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We think the explanation for this relationship is simple. Investors view QE as reflationary. Hence, when the tap is open, you buy risk assets and sell bonds. To illustrate this point, look at the sensitivity of the curve to rates of change in the balance sheet. When it is growing, the curve steepens, in a clear sign of reflation. Yet even the slightest decline in the rate of increase, let alone outright contraction, seems to cause the curve to collapse. Once again, the exception has been the recent flattening, and if it hadn't been for the TGA effect and fears of an economic relapse caused by the Delta Variant, we believe the curve would already be far steeper, perhaps by as much as 100bps.

This reflationary effect is also captured in the near-perfect correlation between the balance sheet and stocks. While not as sensitive as fixed income to tapering, absent another supporting factor such as fiscal spending, equities are very vulnerable when the liquidity tap is turned off.

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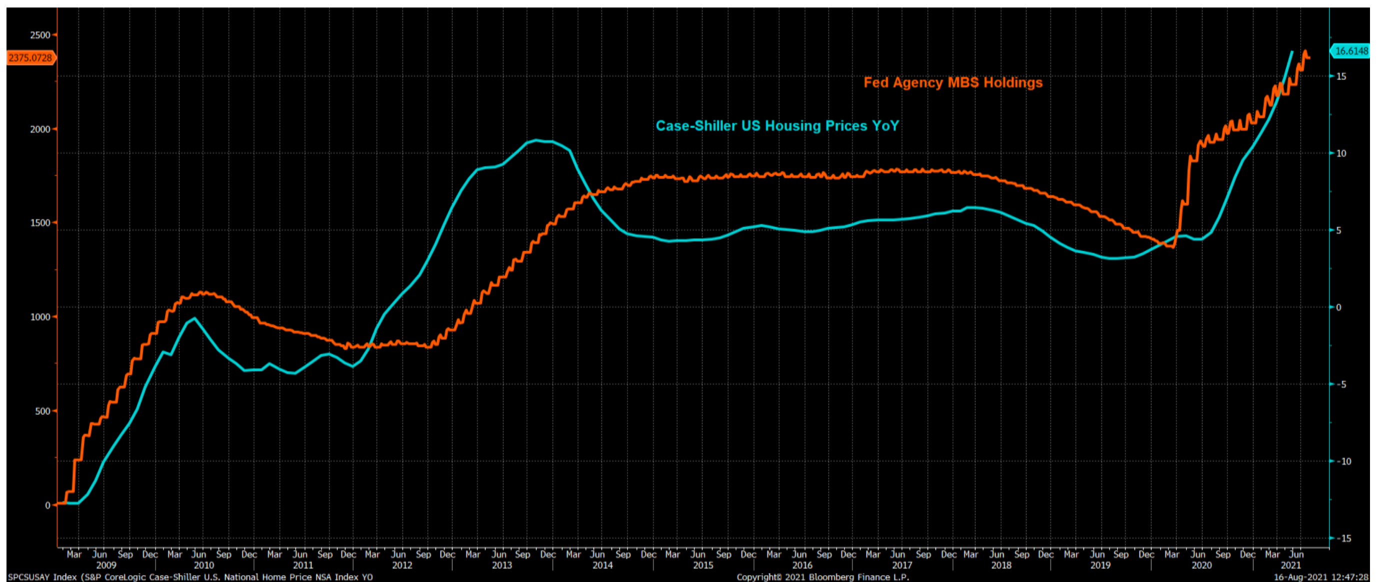
As we have discussed at some length, given the acute financialisation of the US economy, this is a HUGE point of weakness for the Fed. More than any other factor, it explains why the two attempts to shrink the balance sheet have failed! Very simply, any sustained weakness in asset prices feeds back into employment, Capex, and confidence almost immediately ("US: The Real Recovery is Just Starting" 29th June). PS it's not just stocks that are hostage to the balance sheet!



The risks are further heightened because the Fed has implicitly supplied the bond market with convexity, effectively suppressing volatility via its purchase of MBS. Think of it like this. When you take out a mortgage in the US, you have the ability to refinance. As a result, the holder of the mortgage, typically a bank, is short that optionality, which is usually hedged and creates demand for volatility. In marked contrast, when the Fed buys MBS, it does not hedge, effectively leaving the market flush with convexity. Hence, as they taper, we face the prospect of higher demand for vol just as the curve come under pressure.

That brings us to the next problem, the dollar. As the dollar's price action during QE1, QE2 and QT shows, shifts in the Fed's balance sheet can exert massive pressure on the currency. Hence, all else equal, a unilateral move by the Fed to start tapering could, as we saw in 2014, catapult the dollar higher and raise the risk of deflation. A repeat of 2018's QT would be just as powerful.

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However, as we have discussed, FX is a little more complex this time because we have to consider the relative stance of central banks ("The Fed – An Unreliable Boyfriend" 18th June). From 2013 to early 2014, offsetting policies from the BoJ and ECB kept the dollar broadly in check despite the Fed's QE3. Fast forward, and it's not hard to argue that most G10 central banks have over eased. Therefore, when the Fed tapers, if its peers follow pari-passu, the dollar reaction should be muted. Furthermore, the current dynamics are very different to 2014. Back then, the US current account deficit had collapsed as domestic crude replaced imports, thereby reducing a key source of dollar supply to the rest of the world and leaving a structural shortfall at the heart of the reserve system. Hence, in 2014, as soon as Yellen announced tapering, the dollar exploded.

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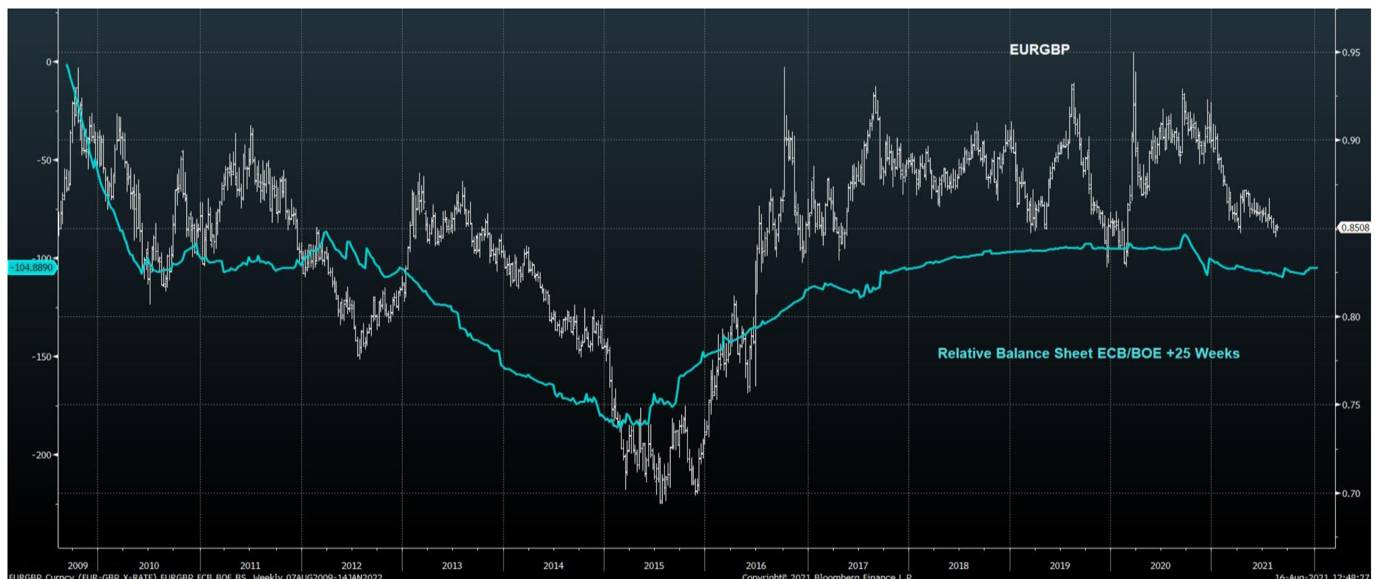
In stark contrast, this time around, our work suggests that the long-term factors are far less dollar supportive. Indeed, quite the opposite. Hence, unless the Fed is extraordinarily aggressive, the impact on the dollar will be more muted.

As a slight aside, with the BoE possibly moving to taper, we would remind you that EURGBP appears to be very sensitive to the relative size of the BoE/ECB balance sheets. Ultimately, we expect the ECB will also follow suit, but if the Old Lady starts the ball rolling, there is a clear downside risk on this cross ("MI2 Trader: EURGBP" 6th August)



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So, where does that leave us? Essentially, we believe that, like the last two tightening cycles, any attempt to normalise financial conditions is ultimately doomed to failure. As the saying goes, "the definition of insanity is doing the same thing over and over again and expecting different results".

This time, given current long-term supply dynamics and the need for the Fed's peers to also tighten, we are less worried about a sustained deflationary spike in the dollar. The Fed's recent announcement of a permanent repo facility for foreign central banks also significantly reduces the risk of a dangerous risk-off dollar squeeze ("The Napalm Run" 18th March 2020).

Instead, the big concern has to be US stocks. On virtually any metric, they are expensive, and history suggests that as soon as the Fed tapers, they lose momentum, which technically increases the risk of a sizable correction. Furthermore, given the feedback between equities and employment/Capex, even a period of sideways price action, let alone a sharp sell-off, will be felt rapidly in the real economy. Hence, we believe that the Fed is snookered, struggling with feedback loops that will box them into a corner and why they will ultimately have no choice but to weaken the dollar ("The Dollar: Triffin's Dilemma and the Impossible Trinity" 24th March)

In terms of timing, it is possible that, until the balance sheet stops expanding, which won't be until next summer, equities hold in and, as we saw in the last two tightening cycles, it takes two years to create sufficient market pain to force the Fed to pivot back to easing. In that regard, signs of peaking inflation or slowing PMIs, which reenforce the slowdown narrative and delay the day of reckoning, should be welcome. However, as we discussed in our latest video, there is still a lot of momentum in this economy, especially in employment, the Fed's singular target. Hence, we, for one, don't believe they can dilly-dally. What's more, unlike 2014 and 2016, the fact that the Fed has kept the metal to the floor for so long means that when they do start to tighten, they'll need to move quickly ("MI2 Trader: EDs" 9th August)! This is something we are pretty sure a nose bleedingly expensive equity market won't take well.

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