RUBRICS

Breaking the Mould

Fixed Income Macro View

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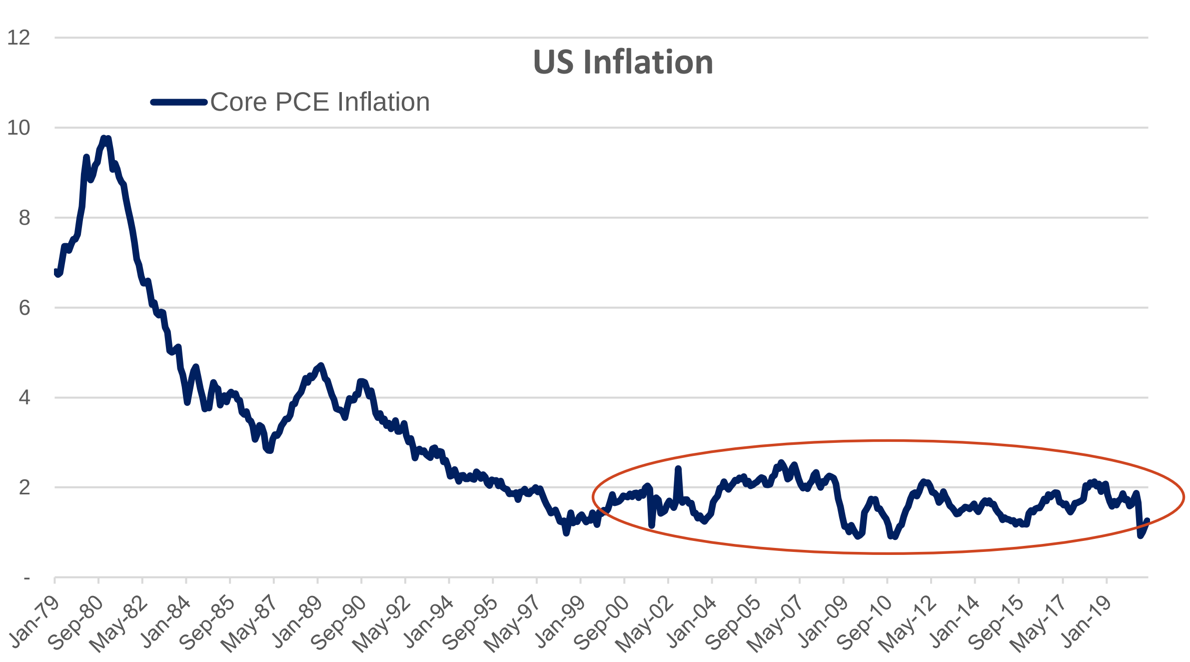
The relationship between economics, politics and financial markets is symbiotic, with substantive shifts in one often giving rise to large changes in the others. The pandemic, and the global response to it, has resulted in significant economic disruption, altered the leanings of the political establishment, and led many to question whether we are on the cusp of breaking a 40-year trend of declining inflation. The global bond market has certainly taken notice with the US yield curve (2s10s) steepening some 100 basis points since the surprise Democrat win in the Georgia Senate Runoff on the 5th of January. With the consensus view that this has essentially paved the way for unfettered fiscal spending, spectacular forecasts for growth and inflation continue to flourish as increasingly investors have eschewed the bond market on concerns over economic over-heating. However, as we will discuss below, the global economy has structural headwinds to growth and inflation which, as things stand, cannot easily be overcome. ***What's more we do not yet know what longer term policy choices both governments and central banks will make which will ultimately determine the long run inflationary outlook.***

Stagnant Inflation

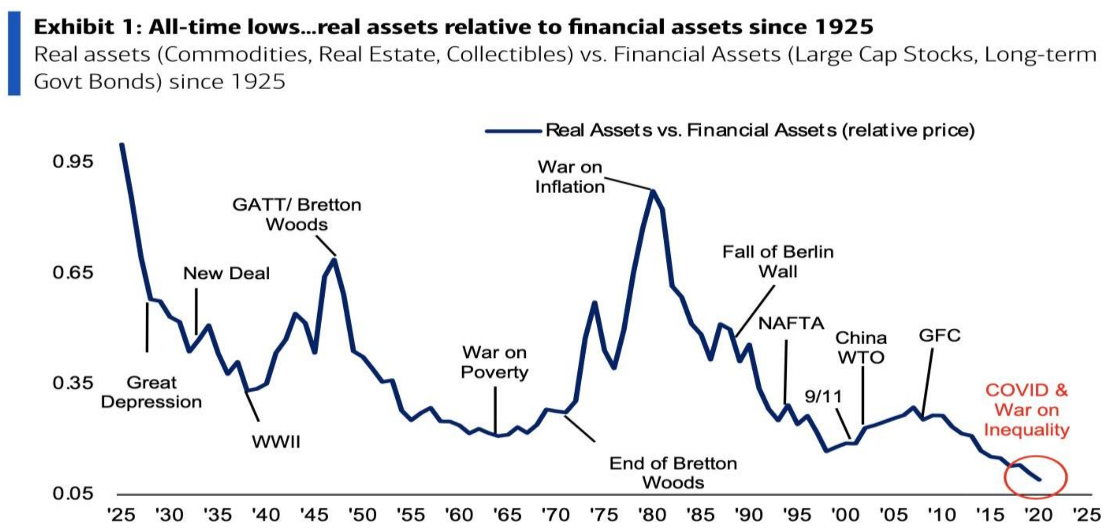


Source: Bloomberg as at 26/02/2021

Political Regime Change

Since the early 1980's the world has been on an extraordinary geopolitical, technological and financial journey. This began with Ronald Reagan's supply-side economic model (lower taxes, lower govt intervention etc) and was followed by the Great Moderation which promoted the ideals of Milton Friedman and the doctrine of monetary policy excess. This created the conditions for a marked political shift as parties on the left (from Clinton to Blair) moved to the centre in a bid to capture the voting middle ground.

Ratio of Real to Financial Assets at Record Lows



Source: BofA 31/12/20

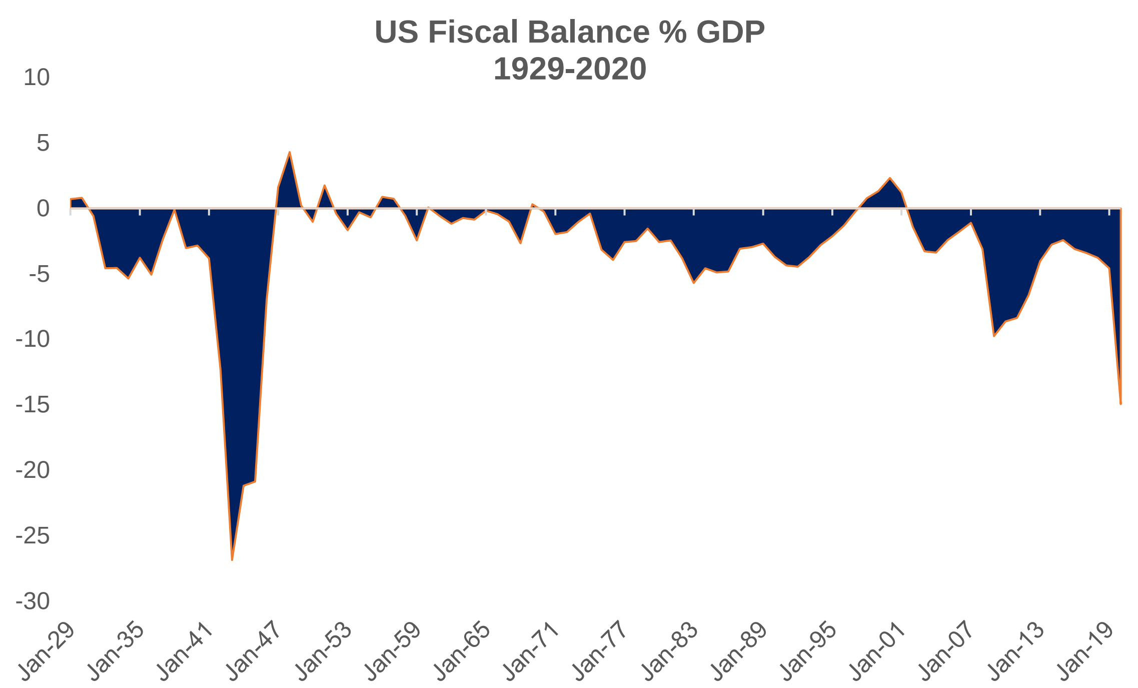
Decades of loose monetary policy and declining productivity contributed to a continued increase in inequality - exacerbated by post GFC policy response – QE and ZIRP. Facilitated by globalisation, the continued decline in living standards of the middle classes provided the perfect breeding ground for a rise in populism. ***This time it was the global conservative movement who had the disenfranchised blue-collar worker firmly in their sights, as the political right was pushed towards the left.*** In spite of the recent Democrat victories in the Senate and the White House, this dynamic appears not to have lost momentum as political discourse continues to rage.

In the US the functioning of the body politic has been compromised by an extremely divided populace. Europe has also seen some disruptive political sentiment from far-right movements if not quite to the same degree. On top of an already polarised electorate, new challenges are appearing in the aftermath of the Covid pandemic. The upshot of this, is that Biden has, in reality, a very short window of opportunity to bring America back from the political abyss. It is perhaps this, more than the economic challenge itself that may well define his presidency. Accordingly, will he prioritise a war on inequality over the wellbeing of the financial economy?

Economic Regime Change

Driven by an over-reliance on loose monetary policy, the once great industrial economy that was the US, underpinned by savings and investment, has morphed into a financialised economy powered by consumption and asset bubbles. A cycle that began in the 80s and peaked prior to the Global Financial Crisis, continued through the last decade with little done to address the underlying structural headwinds (debt saturation, lack of productive investment). Low interest rates and high financial asset prices were the defining features of the so-called secular stagnation. Change, however, is taking place. The response to the Covid crisis has been eye-catching both in scale and what it represents from a political standpoint. Last year 27% of US income came in the form of fiscal transfers while the recent Covid recovery bill is supported by over 70% of the population - including a high proportion of Republicans.

Extraordinary US Fiscal Deficit



Source: Bloomberg as at 31/12/2020

This shift in economic support from central banks to governments represents the largest regime change in western economics in over a generation. The economic orthodoxy of Reaganomics has well and truly been laid to rest with the Tea Party movement nowhere to be seen.

What this means is that policy, critically, will no longer be directed purely at financial markets but rather the real economy. Big government spending programmes, however, aren't always the clear and obvious panacea their advocates would have us believe. It is not surprising that parallels have been drawn between today's fiscal push and that of Franklin Roosevelt's New Deal. Interestingly at that time many were not convinced of its effectiveness. In fact a March 1939 American Institute of Public Opinion poll[1] suggested 66% of people believed it would delay the business recovery, in spite of unemployment running at 20%. Of course things today are very different and we are not suggesting a new 'new deal' cannot be positive. What we are saying is how it is structured will be fundamental to its success.

1: https://mises.org/library/disaster-called-new-deal

More generally, ***shifting the focus from a top-down approach to a bottom up one is a critical step in addressing the failures of monetary policy*** - aimed almost exclusively at large asset owners. Biden's policies will hopefully set the right incentives for the broader economy and not mirror the bad ones that central banks have encouraged over the last decade. Examples do exist of how lasting positive outcomes can result from fiscal support. The technological advancement from the space race in the 1960's and 'Reagan's Star Wars' programmes gave the US an edge the private sector could ultimately leverage and use to successfully drive growth. Could something similar occur today with a private sector incentivised to develop clean technologies?

We would however offer one clear note of caution. Without a lasting economic multiplier there is a danger that fiscal programmes will become both as ineffective as QE and as permanent (remember QT lasted less than a year). In order to close the inequality gap and offer real long-term hope for the numerous blue-collar workers, education, infrastructure and corporate capital investment must be targeted by the Biden administration. Long-term goals cannot be achieved through fiscal transfers alone. While this can support a few quarters of economic growth, its withdrawal could mirror the attempts of central banks at quantitative tightening. While the markets may not like it in the short run, the debt projections of most governments already look stretched, low interest rates or not. A choice may have to be made between the stock market and the real economy.

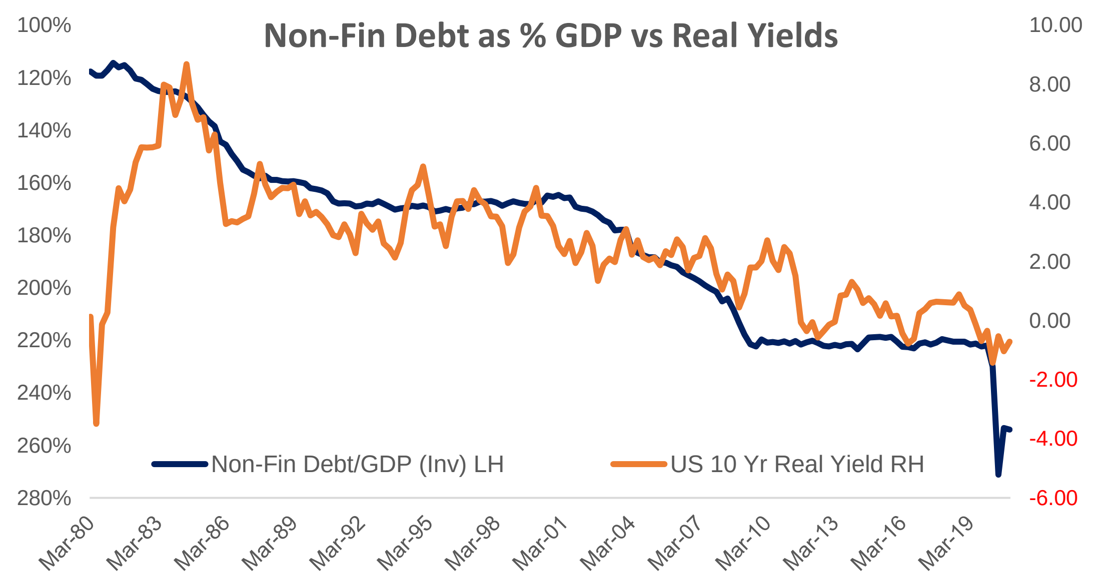
Financial Market Regime Change?

In spite of the question marks over the effectiveness and sustainability of fiscal policy, the sheer scale of the fiscal intervention has helped push inflation expectations to cyclical highs. The fact that this comes against a backdrop of strong economic data, and that it may not be the last of such outsized packages, has certainly spooked some bond investors. Against this however there are structural counterbalancing forces in addition to unknowns regarding future policy decisions that will ultimately dictate market directionality. We explore some of this issues here:

Headwinds

The current outlook is suggestive of very strong growth resulting from a combination of pent-up demand, stimulus and base effects as we hit the one-year anniversary of the global lockdowns. However once the initial 'sugar high' is past, what then? The clearest headwind is the scale of the debt in the system – amplified since the onset of the pandemic. Absent some form of de-leveraging via the 'creative destruction process', this will act as a severe drag on growth, and ultimately cap how far rates can go in the medium to long term.

Ever Higher Debt Levels Require Ever Lower Rates

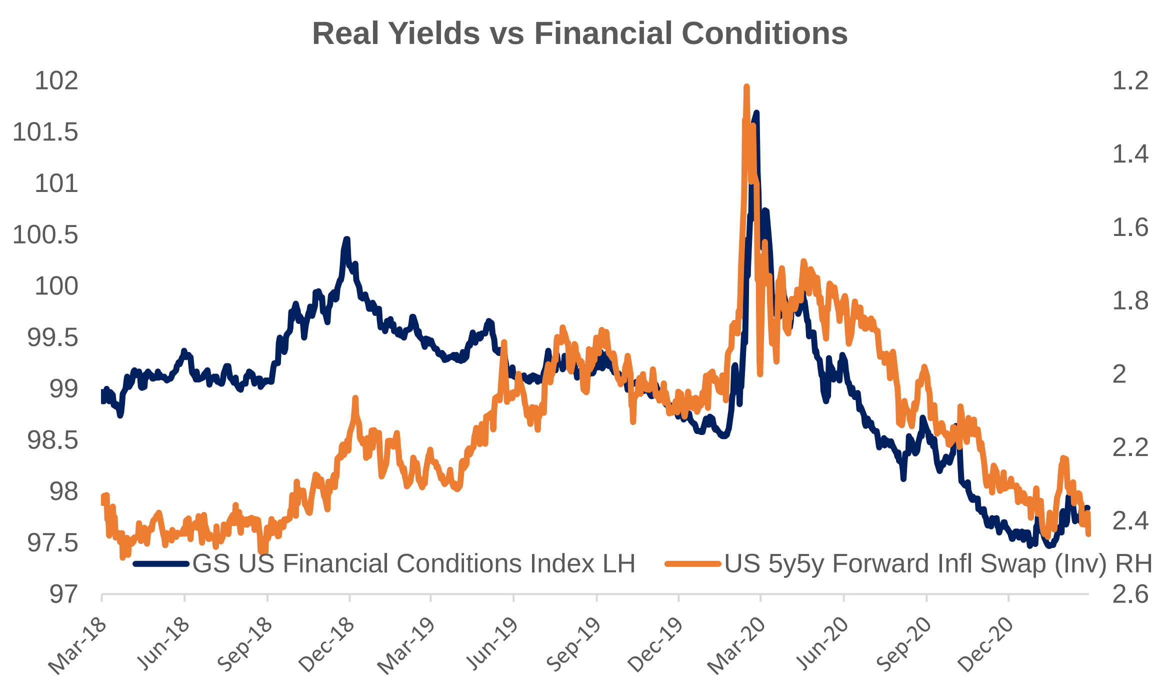


Source: Federal Reserve Bank of St Louis as at 31/12/2020

Policy Response

The Fed have thus far avoided any verbal intervention allowing the bond market to find its own equilibrium. This has been effective at taking some of the froth out of the more extremely valued markets. However as fiscal programmes roll off and rates move higher, structural forces will eventually begin to re-assert themselves. It is unlikely however that the Fed will look to act until financial conditions tighten meaningfully. This can begin to reveal itself through rising real yields, as falling inflation expectations reflect a declining outlook for growth. Cue wider credit spreads.

Rising Real Yields can Tighten Financial Conditions



Source: Bloomberg as at 26/03/2021

Absent a major financial shock, the response in our view may be something more along the lines of an operation twist than a direct provision of support to the equity/credit market. Unlike his predecessors, Powell’s background does not suggest he is driven by any over-arching ideology. Will this prompt a more common sense approach? Perhaps the experience of the BoJ in respect of their absolute ownership of the equity ETF market will provide a note of caution when it comes to direct market intervention. Time will ultimately tell.

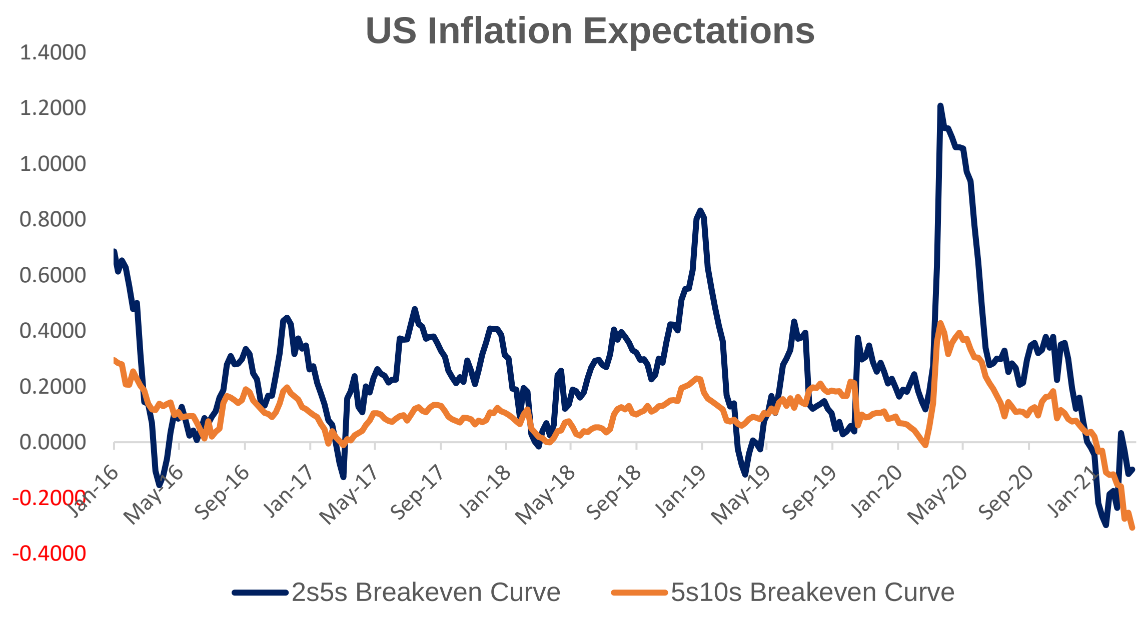
New Paradigm for Asset Prices?

A more radical response to a tightening of economic and financial conditions is outright yield curve control. This in our view may well represent the worst of all worlds. The real threat of inflation for an economy comes from large scale capital outflows and prolonged currency weakness. Pushing real rates any lower than we see today could potentially mark the end of the Dollar’s reserve currency status. If the market begins to lose faith in fiat currency and/or the central banks ability and willingness to control inflation, all bets are off as regards financial assets. However none of this is lost on the Fed, which in our view makes this an unlikely outcome.

Market Outlook

As real yields have risen capital markets have sat up and taken notice. The myopic nature of the investment community will more than likely result in overreaction to the incoming economic data which we expect will be strong in the short run. A higher rate environment can lead to significant repricing of not just some growth stocks but ultimately credit markets as well. As for bond yields, they will likely continue to rise, until financial conditions start to tighten. While there is enough fiscal support to postpone this eventuality in the short term, structural headwinds are such that rates will ultimately need to move lower. This may mean that we are closer to the end than the beginning of the current bond market selloff. In fact looking at 5 versus 10 year breakevens, we can see the market is already beginning to re-price to lower inflation expectations.

Flattening Breakevens Curve Signalling LT Deflation



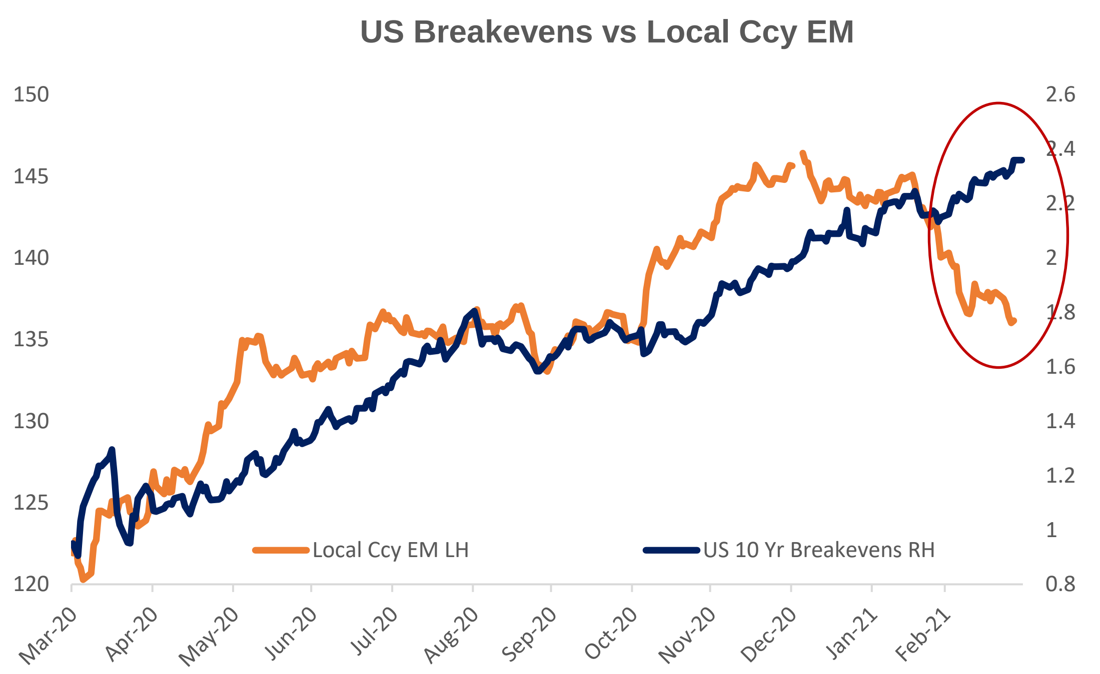
Source: Bloomberg as at 18/03/2021

Zombie Debt Represents Headwind to Growth/Inflation

Source: Bloomberg as at 31/12/2020

Longer duration credit markets will continue to be under pressure in the short term, as a lack of spread provides little protection against sharp increases in yield. Short term bonds (sub 2.5 years) should be well supported in the year ahead given the liquidity that will be pushed into the market from both the Treasury unwind of its balance sheet and transfer payments. In spite of tight valuations, lower rated areas of the credit market may continue to outperform on a relative basis, however when rates look to have peaked this dynamic may begin to reverse.

Reflationary Forces Facing Headwinds?



Source: Bloomberg as at 26/03/2021

The outlook for the dollar will also be important for risk assets. Some of the reflationary forces that were clearly evident in 2H 2020 (weak USD, rising inflation expectations etc) appear to be coming under pressure. The sharp move higher in US yields has shifted momentum back towards the dollar, with EM FX in particular coming under pressure as a result. While USD negatives do remain – e.g increase in US banking reserves as TGA balance sheet draws down – the short dollar trade is perhaps not the one way bet that it was. That said opportunities are certainly emerging in some of the stronger EM currencies.

While there is no doubting that the inflation question represents today's dominant narrative, there is a risk that the market is collectively ignoring a far greater risk. That of financial instability. Afterall it was not an inflation surprise that saw cracks in risk assets in 2000, 2008, 2011 or 2020. While Biden and Powell will hope there is enough economic momentum to avoid a severe market correction, should this not be the case we believe that some effort will be made to prioritise the stability of the real economy over the elevation of financial markets.

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