RUBRICS

Challenging the Narrative

Fixed Income Macro View

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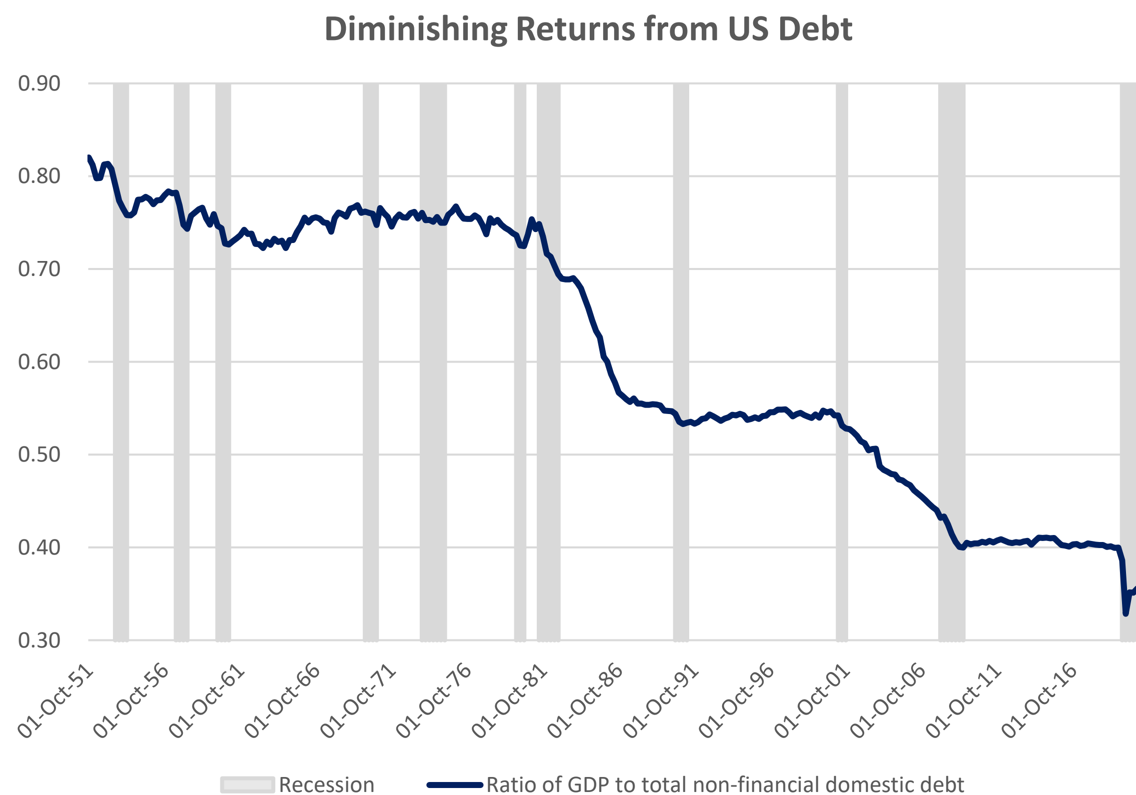
Changing Paradigm

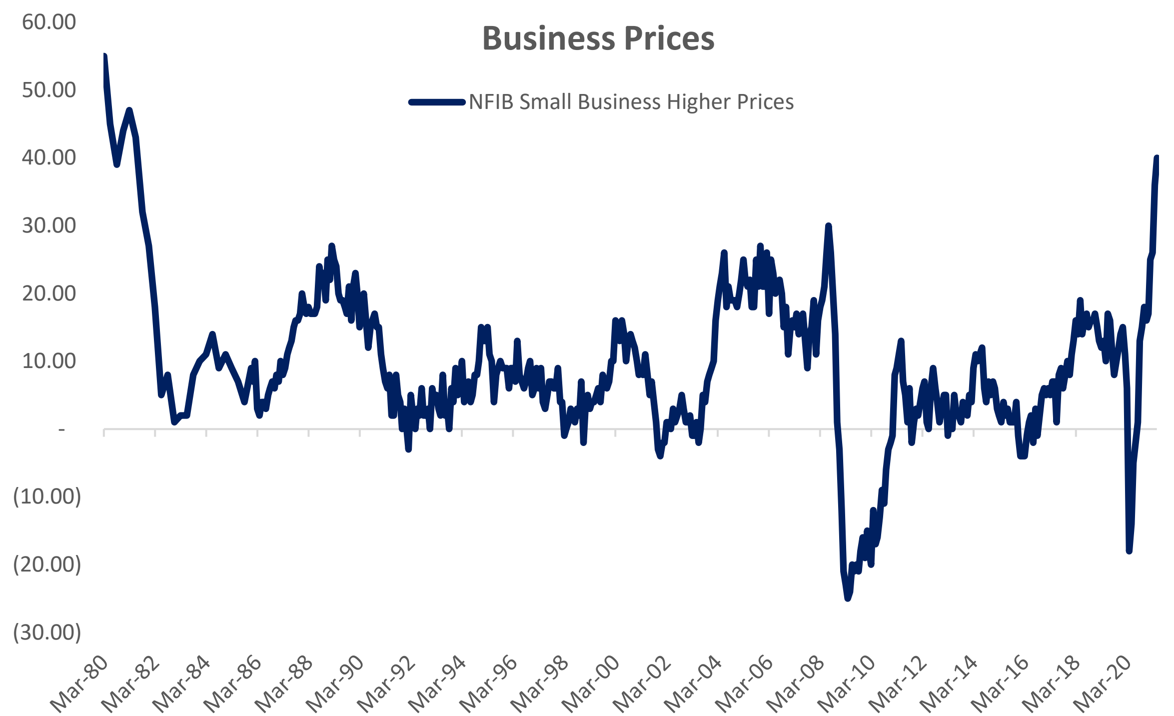
When in the future we reflect upon the many changes that have occurred over these past 18 months, perhaps the most profound, in an economic sense, will be the decline of the neo-liberal order. That is to say, the market-oriented, ‘small government’ model of the past 40 years or so has had its day. Rooted in the monetarist ideologies of Milton Friedman, and sponsored by Ronald Reagan, the clock has been ticking on this economic paradigm ever since the law of diminishing marginal returns kicked in many years ago. Central banks, in effectively eschewing their price stability mandate and focusing exclusively on employment, have been able facilitators of this economic strategy in their progressively forceful approach to monetary loosening. All of which has underpinned the ‘goldilocks’ narrative that has consumed financial markets as ever-increasing liquidity injections created an aura of palpable complacency. Today it feels like we have reached the peak of this cycle.

Slow Decline of the ‘Old Paradigm’



Source: Bloomberg as at 31/01/21

Rising Business Prices – Transitory or Prolonged?



Source: Bloomberg as at 31/05/21

So what has changed? The old mantra of ‘corporations first’ is fast losing its political appeal with tax increases being discussed for the first time in many years – irrespective of how diluted this first iteration may be. Meanwhile the brunt of the cost of tackling climate change is landing squarely at the feet of the business community, which in addition to the growing scrutiny on their collective social responsibilities, represents a core part of the future political agenda. As regards policy, fiscal has now taken over from monetary in being the incremental driver of growth and given its current popularity amongst even the most right-wing of Republicans, looks like it is here to stay. It goes without saying that no one can predict the outcome of this nascent economic model, but what we can say, is that a shift in emphasis can have a profound effect on market expectations, potentially via higher prices and/or a more challenging growth outlook. An outcome that could certainly jolt the markets from this prolonged apathy.

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June 2021

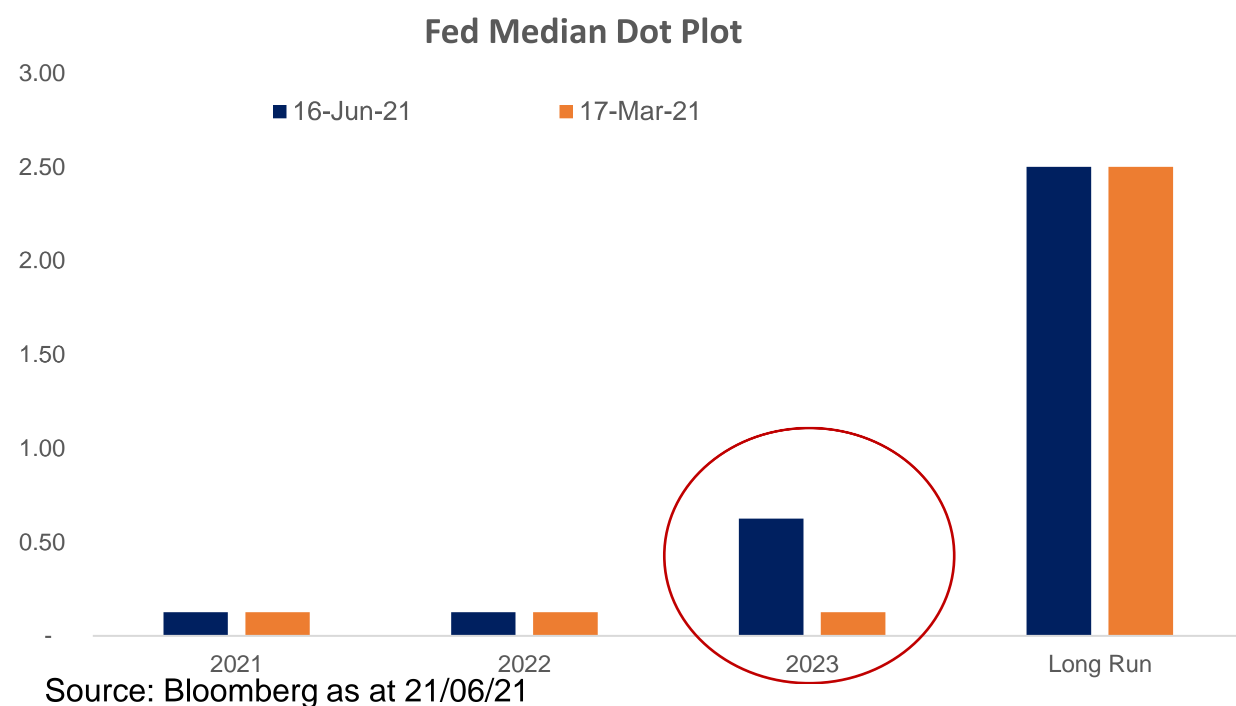
Hawkish Surprise?

In the face of these shifting tectonic plates, the Fed threw the markets a proverbial curve ball at their last press conference by announcing, wait for it, they are now allowed to talk about tapering. There was a distinctive shift from the hitherto ‘transient’ inflationary tone, to one resembling a more conventional inflation fighting central bank. This will not have come as a surprise to the increasing number of talking heads warning of the palpable inflationary threat, including a growing number of former Fed officials. However Powell himself remains unconvinced, appearing more inclined to focus his attention on the jobs market and the threat of deflation as opposed to combatting inflation. On this note, it is interesting that the Fed have yet to address the issue of why they think the greatest explosion of peace time stimulus, both fiscal and monetary, can only muster a temporary thrust of inflation.

The Fed now is completely cornered in a trap of its own making. Unable to understand even the basic consequences of QE and excessive unproductive liquidity - damned if they do and damned it they don’t on monetary policy. At the recent press conference, it somewhat beggared belief that not a single question was asked on MBS purchases or financial stability. Touchy subject? As they struggle with the transient inflation from second hand car and lumber prices, there are genuine structural changes going on which as always they will struggle to recognise given their backward looking world view.

The initial market reaction to the Fed’s tepid effort to address growing inflation concerns may be sowing the seeds for greater volatility down the line. Within just 48 hours of the Fed announcement, one could be forgiven for thinking we have entered a deflationary bust. However if, as we expect, the jobs data improves along with the rents component of the CPI (OER) over the coming months, it wont take much for the market perception of the Fed to shift into the overly hawkish camp. To be clear the inflation story is not over yet, with significant inflationary/growth impetus to come over the next 6 months as the global jobs markets roars back to life. We are on the home stretch of the end game, albeit a winding one.

Dot Plot Increase



Source: Bloomberg as at 21/06/21

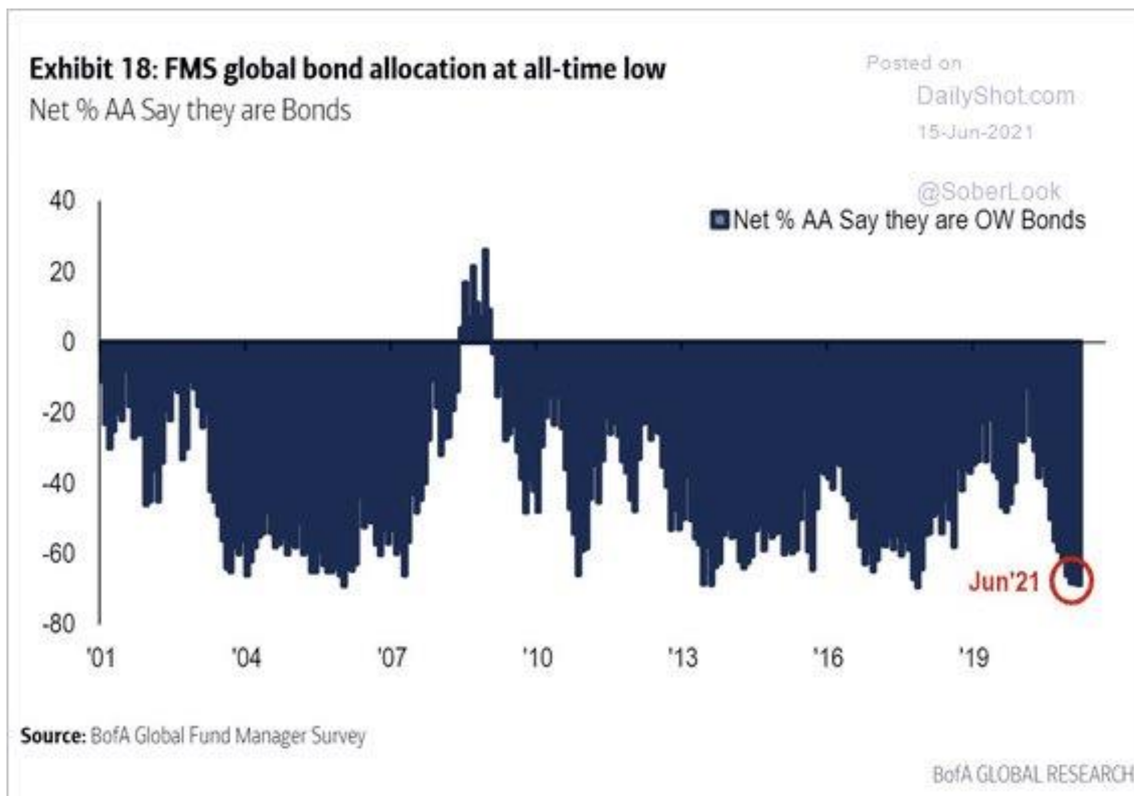
MBS Spreads

Source: Bloomberg as at 21/06/21

Outcome of the Last Cycle

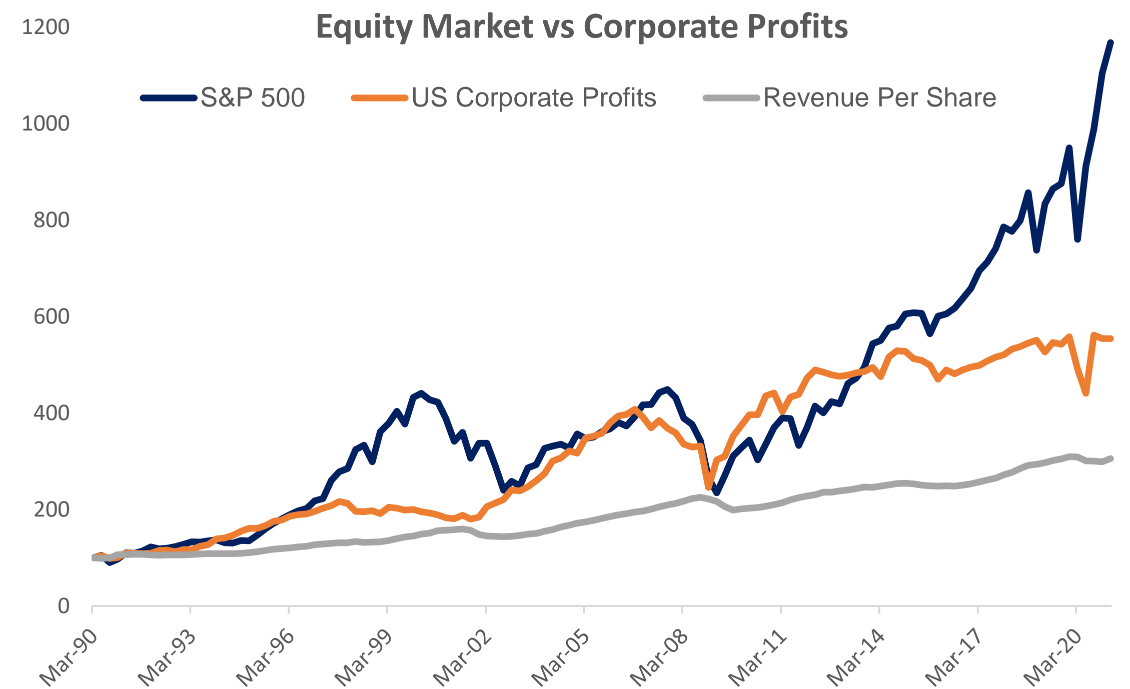
The current sense of market complacency is riddled with contradictions. So often in the post-GFC period all scenarios have been bullish for risk assets. Higher inflation is evidence of the strength of the economy, while deflation means more Fed asset purchases. Risk, for what it's worth, has been completely discounted from any future asset allocation models. Equity investment, along with market leverage, is at record highs while junk bond yields are at historic lows. In many cases government bonds are providing heavily negative yields, both on a real and nominal basis. All of this is predicated on the belief that the economy is booming and will continue to boom, inflation won't run too hot or too cold and the Fed can therefore continue monetizing trillion-dollar deficits indefinitely. Accordingly, the market is confirming that there will be no further deterioration in east west relations, the standoff over the Northern Ireland protocol will be resolved, governments won't need to close the loopholes on corporate tax and climate change will reverse itself without any real disruption. Is this really credible?

Global Bond Allocation at All Time Low



Source: Bank of America as at 14/06/21

Valuations vs Fundamentals



Source: Bloomberg as at 31/05/21

The answer ultimately is that no one cares. History suggests the only thing that really matters is the fact that the Fed has the markets' back – a rational conclusion drawn from a decade plus of extraordinary monetary support. How, I hear you ask, did it come to this?

Reinforcing Complacency – Central Banks

Quantity Theory of Money P * G = M * V

The greatest failure of the pre-covid economic thinking was the unwavering belief that money supply - through central bank liquidity (debt) injections - would be enough to drive economic momentum. By switching the focus towards employment as their ultimate goal, central banks had the necessary cover to continue accommodative policy long after many felt it was warranted. However in the end the only thing this achieved was a major run-up in asset prices, far in excess of the levels of growth witnessed in the real economy. A 'non-expansionist fiscal policy' coupled with a contracting banking system lay at the root of the problem and meant any money created in the system inevitably found its way into financial assets.

Current thinking is looking to reverse this pattern, primarily through fiscal policy, in an attempt to stimulate the real economy over the financial one. Despite the fact this can result in a markedly different economic outcome to that which we have become accustomed to, the market continues to lap up the old goldilocks narrative. Why is this the case?

Current Market Narrative –Transient Inflation

In spite of the near 30-year highs in certain inflation readings, the Federal Reserve have, until very recently, been quick to dismiss any price increases as transitory. While the shift in tone from the Fed has been discernible, the market at present appears comfortable with the idea that the Fed will be able to deal with any inflationary problems. It is likely therefore that the debate will continue to rage pitting a number of short and longer term factors against one another (see opposite).

One of the more striking market reactions of late has been that of the bond market, not exactly screaming inflation. However we would not be too quick to read into the signalling impact of this, given the scale of technical factors at play. While the ongoing global central bank QE programmes are hoovering up vast quantities of sovereign debt, the sheer scale of liquidity in the system is pushing investors out the yield curve due to the negative rates at the shorter end. Other price-insensitive players like pension funds, commercial banks and central banks' currency management programmes have also been buying sizable chunks of the bond market. The final nail in the coffin for those betting on higher yields was the short squeeze that has most recently ensued, as a number of programmatic strategies have been unwinding short positions leading to yields gapping downward. Given the technical nature of the move, it is too soon to say that the bond market is categorically rejecting the inflation story. What is clear is that at no time did sovereign bonds look reasonably priced given the current inflationary outlook, as the market continues to discount the risk that genuine longer-term inflationary pressures may be coming into play.

Consensus vs Non-Consensus Inflation View

Transitory Phenomenon	Structural Shift
Fiscal Disappointment	**Perma-Deficits**
Passing Pent-Up Demand	**Geopolitical Friction**
Base Effects	**Climate Change**
Temporary Supply Side Bottlenecks	**Permanent Supply Chain Disruption**
Falling Credit Impulse	**De-Globalisation**
Subdued Wage Outlook	**Change in Psychology**
COVID New Strain	**MRNA Technology**

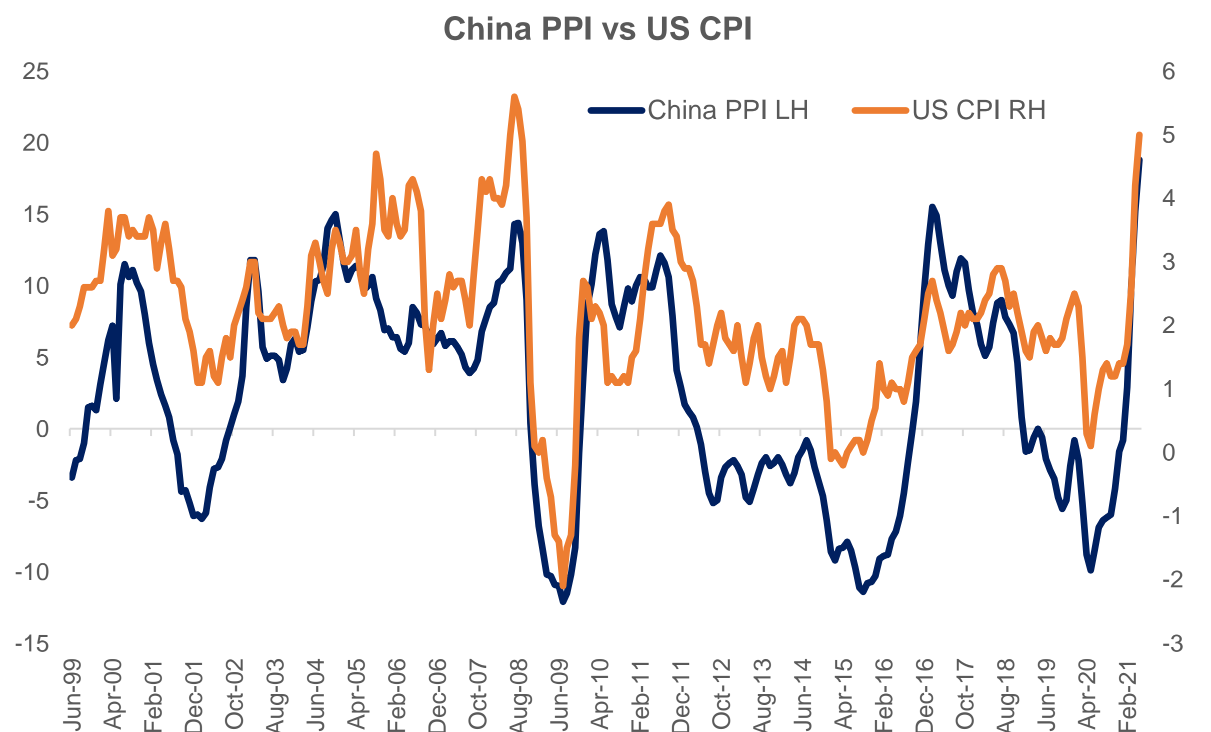
Defying the Consensus – Inflationary Pressures

As alluded to at the outset, we believe some of the structural changes that are occurring at the level of the global economy, are not adequately being reflected in market pricing. While there is no guarantee that we will see a sustained shift to higher prices - we could just as easily see a deflationary bust - the previously unwavering belief that the Fed will always have our back may finally come into question. As a result it is worth examining some of the more structural forces that we believe are here to stay and can present a real challenge to the future policy stance.

It has been evident since pre-COVID times that certain deflationary tailwinds have started to turn. One of the key deflationary forces of the past 20/30 years, globalisation has begun to show signs of reversing itself. There are two key reasons for this; firstly the inherent weakness of stretched global supply chains have been exposed by the pandemic, meaning companies will increasingly look to re-shore domestic capabilities. This will not come without cost. More importantly it is now seen as a political necessity to protect key national IP and perceived competitive advantages. As the political discourse between east and west continues to heat up, significantly, the frictionless global supply chain management between East and West is becoming a thing of the past. At the epicentre of the east/west political dynamic is US China relations. For most of the twenty first century China has been exporting deflation to the rest of the world.

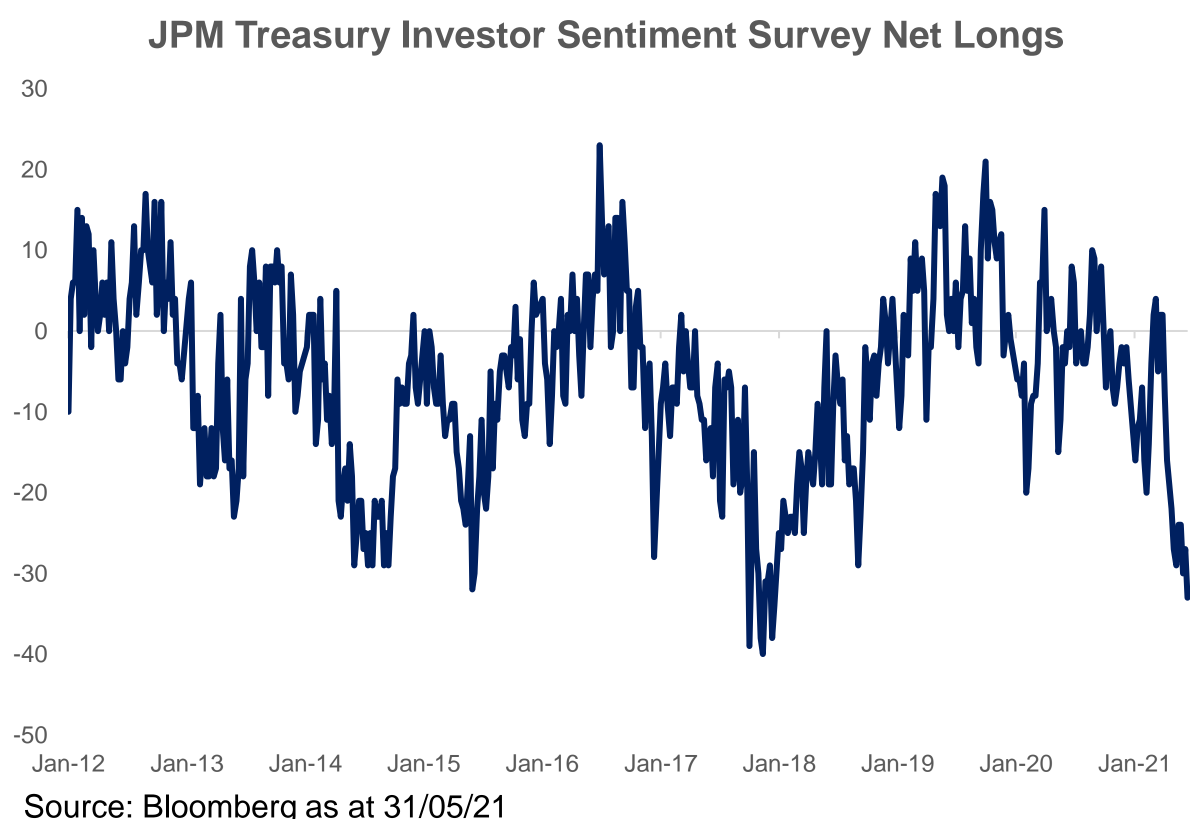
Today, the fact that China continues to move from a manufacturing centric growth model to a consumer-based society is likely to alter the dynamic for global inflation. Increasingly China is becoming an exporter of inflation not deflation, which if sustained can lead to a very different inflationary outcome. Perhaps a more difficult factor to model, but no less significant, the prospect of geopolitical tensions rising can also have a major implications for the global supply of things like raw materials.

Importing Deflation from China



Source: Bloomberg as at 14/06/21

Bond Market Technicals – Heavy Short Positioning



Source: Bloomberg as at 31/05/21

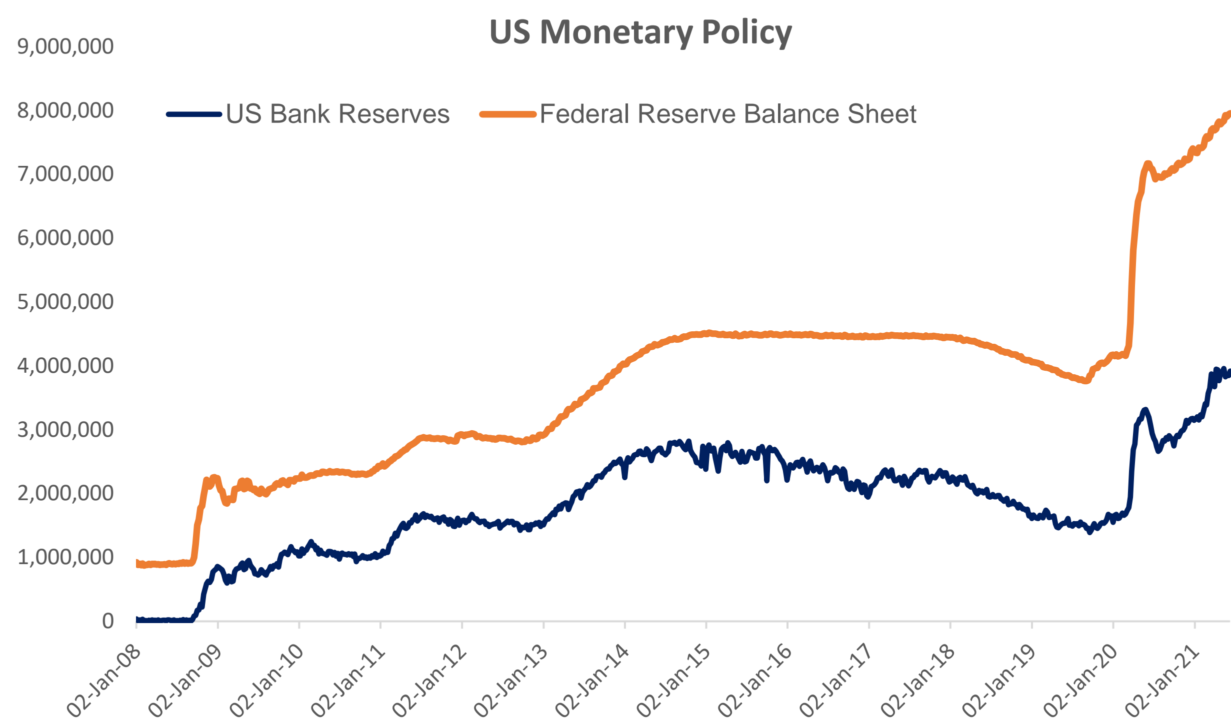
Policy Implications

Fed – Longer-term, were we to see a genuine shift towards an inflationary environment, it would likely require radical policies to counteract it, not least because of the sheer scale of the global debt overhang. Some form of yield curve control is we feel inevitable in this scenario which would place huge pressure on the dollar to weaken considerably. Given the scale of the US twin deficits, this is unlikely to end well with the reserve currency status of the dollar coming into question along with broader debt sustainability. Not a particularly optimistic outcome, despite what the likes of Janet Yellen may believe about higher rates.

Away from the immediate threat of inflation, the plumbing problems around QE programmes continue to build. A case in point is the fact that the Fed has been struggling to keep the EFFR away from zero – it has been very close to the lower bound of the Fed's range. Banks have been so concerned about the additional capital they are required to hold against their growing deposits, they have been forcing clients into money market funds. This is in turn led the Fed to withdraw over half a trillion dollars from the system through their reverse repos on a daily basis. Outside of this, broader markets are showing tangible signs of excess exuberance, with leverage at historic highs along with (aforementioned) levels of complacency. The record rise in house prices is putting significant pressure on the Fed to reduce its MBS purchases as affordability has become a real issue.

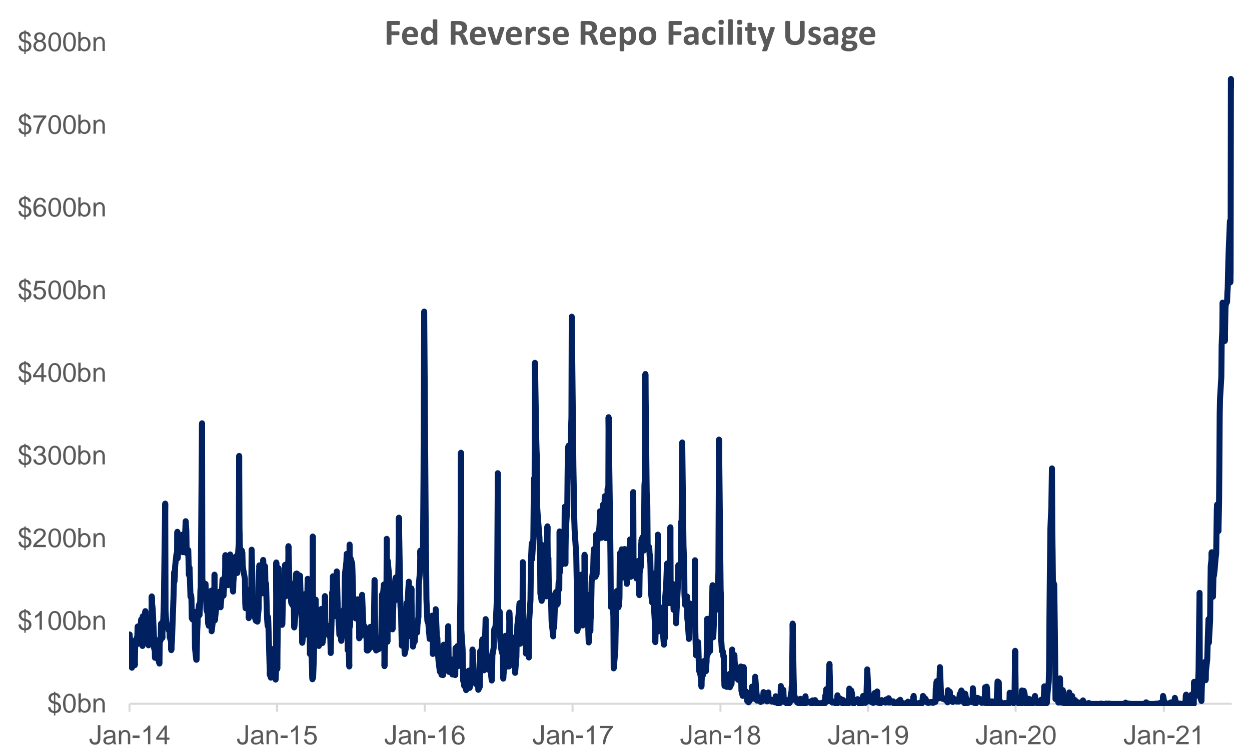
At current valuations further pulling on the QE strings will bring undoubted risks to financial stability, which the Fed should be well aware of in light of their direct role in the Dot Com bubble and GFC in 2008. The Fed needs to taper, the system is under massive strain as it is and if we do hit a post-COVID growth slump there is little the Fed can do, other than reverse repo out any further excess liquidity. How exactly does that help?

Fed Balance Sheet and Bank Reserves



Source: Bloomberg as at 14/06/21

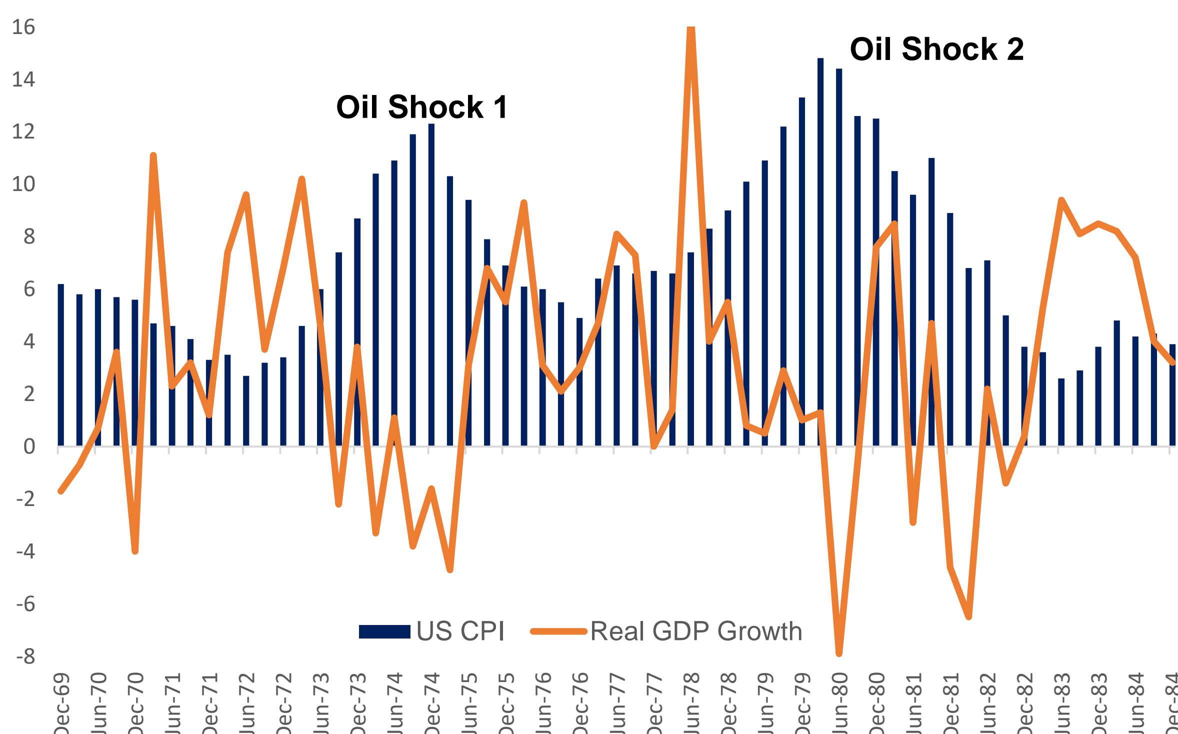
Excess Liquidity – What the Fed is Taking Out of the Market



Source: Bloomberg as at 21/06/21

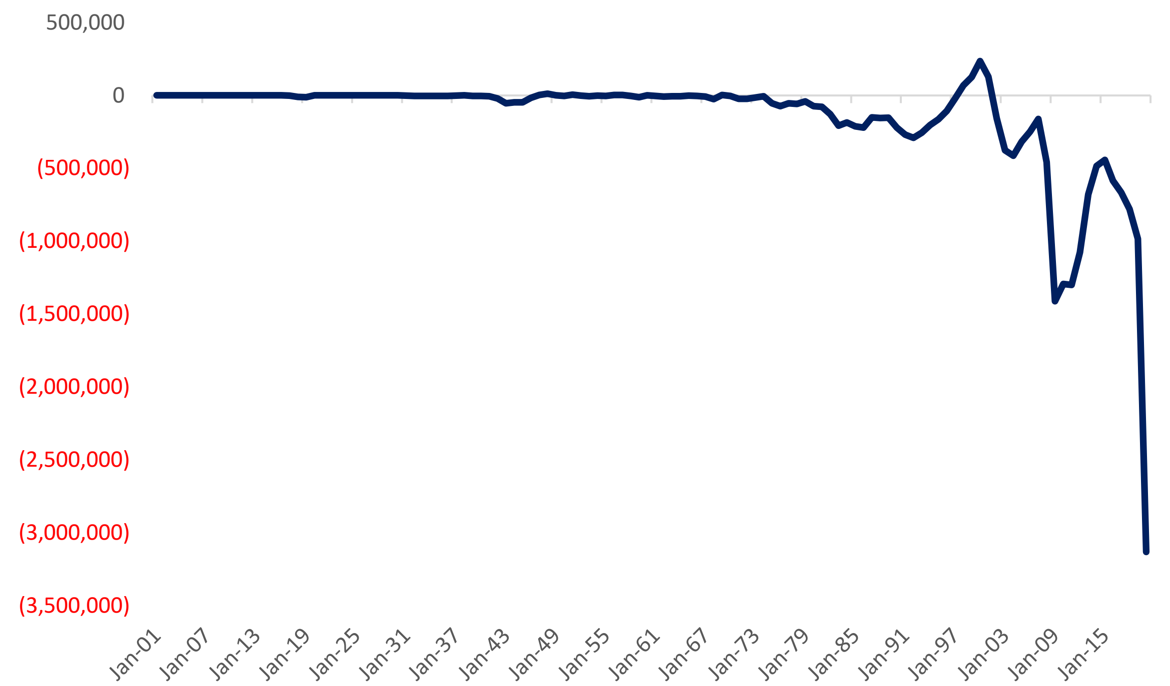
Fiscal - As already mentioned the last economic cycle saw an unprecedented level of benign inflation based in part on the policy mix as stated above, as well as structural forces including globalisation, demographics and debt saturation. If indeed we were to direct vast amounts of stimulus at the real economy as opposed to the financial one, the outcome may indeed change. The net result may be a rising cost of living, which, if captured in the CPI data or even inflation breakevens, will matter to the markets. Politically, a rising cost of living without adequate wage supplements would be a disaster. The late 70's and early 80's provide ample evidence of just how problematic inflation can be in winning elections. On the flip side of the coin we have also seen first-hand the impact that poor fiscal spending can have on economic and political outcomes. The startling rise in jobs vacancies despite the high unemployment figures clearly point to an incentive problem among the workforce on the back of the record stimulus being handed out. This will give the many advocates against excessive fiscal policy the fire power to continue to rail against it. Where does this leave Biden?

Stagflation of the 1970s/80s



Source: Bloomberg as at 14/06/21

Unprecedented Deficit Spending



Source: Bloomberg as at 31/12/20

The president has thus far embraced a progressive agenda, less out of ideological beliefs than political pragmatism. The MAGA crowd have grown accustomed to the stimulus cheques and Biden knows it may represent the only way to win them over. Not lost on the Republicans, who will not want the Democrats to hit home with their voter base, to a person they voted against the recent $1.9trln programme. Outside of politics, the fiscal packages have had a real impact on incomes and spending – neither of which have actually fallen throughout the pandemic. However, as we have seen in the jobs market, there are unintended consequences to direct transfers. As with all opioid stimulus (think QE), the economy can get easily hooked and pretty soon the people might hold back on spending until the next cheque arrives in the post. If the Democrats do manage to get more stimulus across the line, it does run the risk of cementing the inflationary psychology not seen since the late 1960's. This may be bad news for the mid-term elections in 2022 and could result in another lame duck presidency from a domestic standpoint at least.

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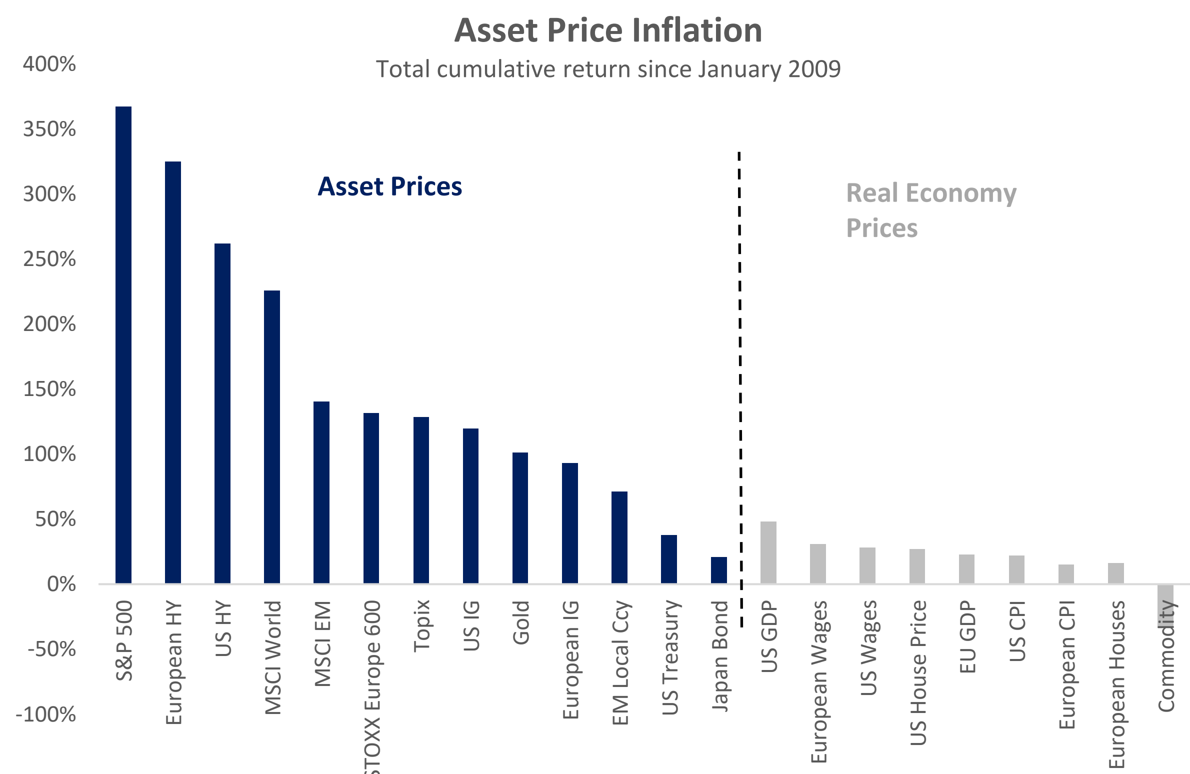
Conclusion

The global economy is on the precipice of significant change, there is no question about that. We will see de-globalisation and increasing tension between east and west as China continues to extend its sphere of influence. ESG and climate change will change the way business will operate and power themselves, while governments will be taking a more active role in economic management to a great degree not seen at any time post GFC. Meanwhile populism will likely move more and more to the mainstream of western politics and the beginning of the end of America's reign as the unchallenged world leader and the dollar as the reserve currency will begin. As a result, historical models centred on credit impulse, which have held true pre-covid might not be as reliable in future. Demographics, globalisation, debt and a neo-liberal economic mindset combined to keep inflation at bay. These factors are changing and with them the risks of inflation are rising again. Twenty years of stable prices exploded in the 1970's on the back of massive fiscal expansion and loose monetary policies.

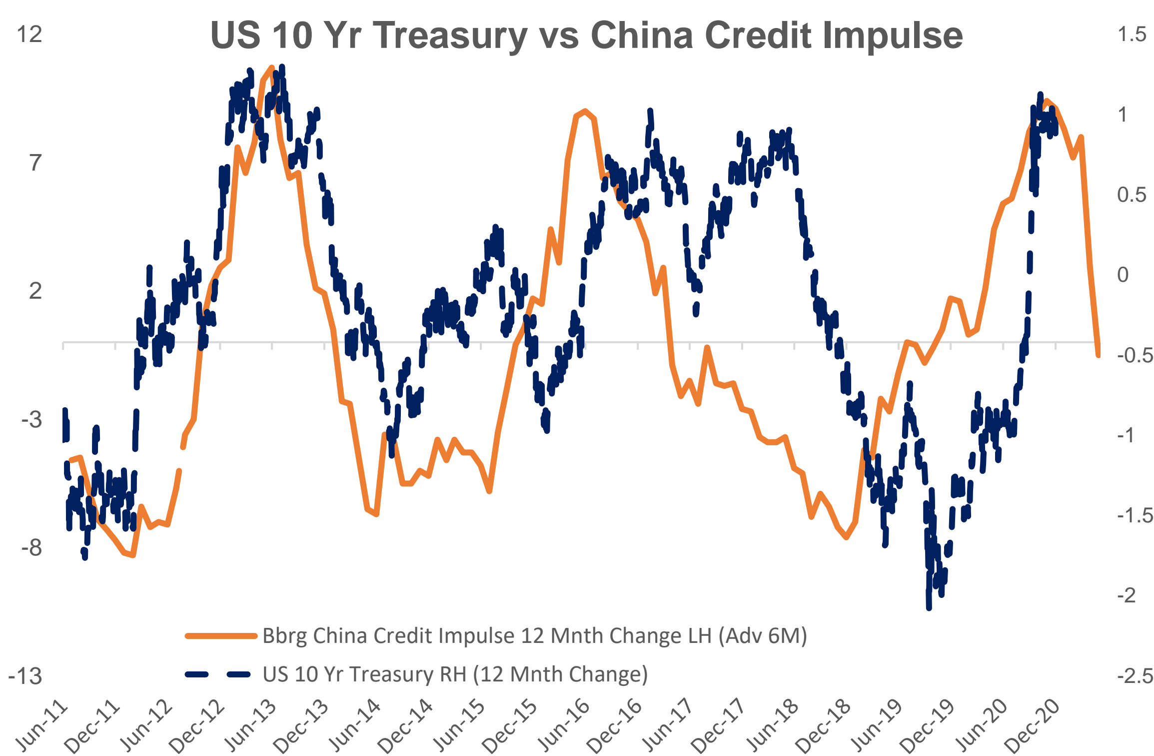
Perhaps Covid is our fiscal Vietnam while YCC could be our de-pegging from the gold standard? Because psychology plays such a massive role in the outcomes of these events, certainty is not something we should project. However, the market seemingly has and that is why over the next 6-9 months new events like Fed tapering might have a bigger impact, given the potential for negative surprise. Ultimately though, the greater risks lie in the fact that climate change and deglobalisation can lead to a more inflationary environment against an increasingly fraught growth backdrop. Challenging times ahead.

Real vs Financial Asset Price Inflation



Source: Bloomberg as at 1706/21

Historical Relationship – China Credit Impulse vs US Yields



Source: Bloomberg as at 31/05/21

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