Global Strategy Weekly

Winds of change are set to blow away inflation fears

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Surveys suggest that inflation fears have become investors' number one concern. But why look at it that way? We could equally say it is investors' own bullishness on the strength of this economic cycle that is driving prices sharply higher in the most cyclically exposed equity sectors and industrial commodities.

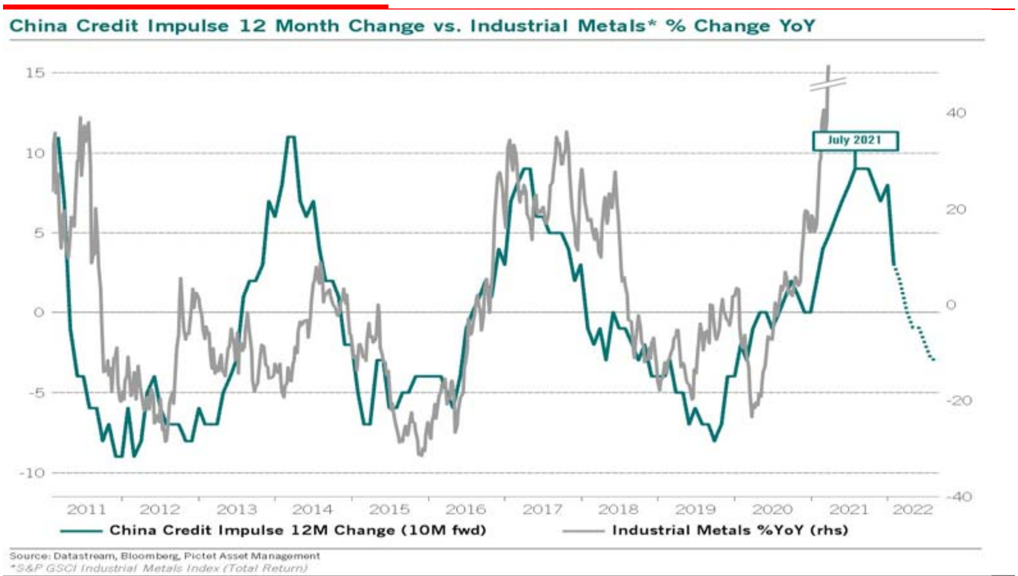
- Bloomberg's John Authers recently pointed out in his excellent daily note (link) that there is a 'reflexivity' to investors' belief in rising inflation. For when they pile into commodities as an investment vehicle to benefit from rising inflation, they create substantial upstream cost pressures – as has been highlighted by PMI corporate surveys. Beyond the cascading effect of upstream commodity price pressures, headline CPIs are also quickly impacted as food and energy prices rip higher.

- In addition to this, the observation by investors that industrial commodity prices are rising only serves to reaffirm their belief about cyclical strength and rising inflation - most especially "Dr Copper", which many investors see as extremely sensitive to economic conditions.

- The circular, or as George Soros terms it, 'reflexive' nature of financial markets makes them extremely vulnerable to being whipsawed. Yet because of the current extreme momentum it would take a very heavy weight of evidence to convince this market to reverse direction.

- We continue to highlight that commodity prices are at high risk of a major reversal because of the steep downturn in the Chinese Credit Impulse. We have highlighted this before and we are not alone – see chart below from Julien Bittel of Pictet Asset Management (you can follow him on Twitter via @BittelJulien).

- When commodity prices do start to fall, expect a major reversal in inflation sentiment. And expect momentum to become as self-reinforcing and reflexive on the way down just as it was on the way up! Indeed, technical developments in the bond market suggest the wind may have already changed direction.



Source: Pictet Asset Management

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

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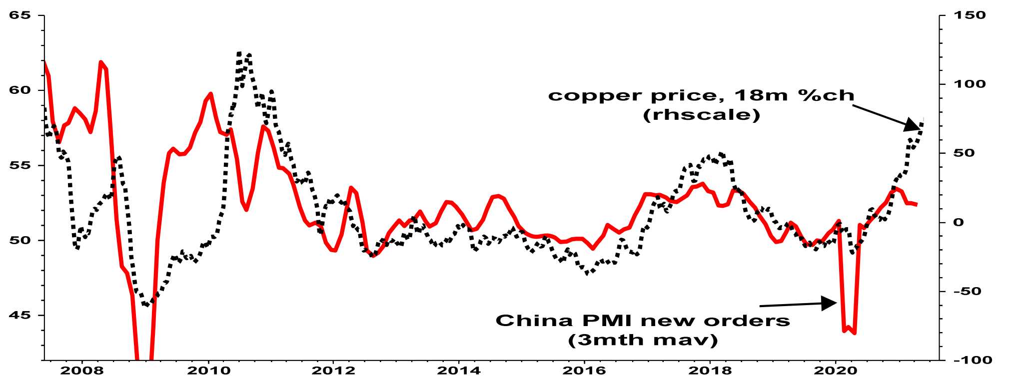
The cyclically sensitive copper price has surged some 90% over the past year. That though is from Covid-19 driven recession lows, so we show the 18-month rise below (+70%), which is still stupendous and totally out of line with, for example, the Chinese PMI.

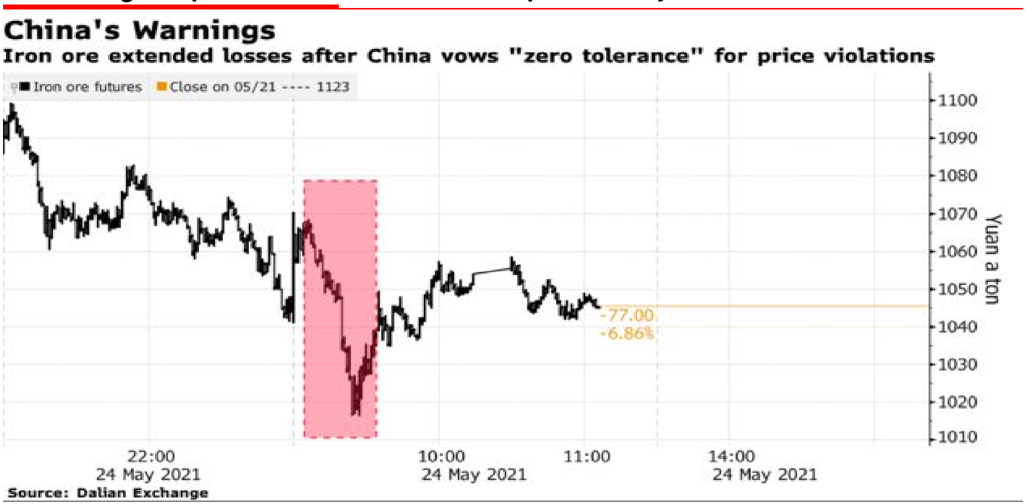
Copper bull market has totally detached itself from the Chinese economy



Source: Datastream

The Chinese authorities are getting annoyed by what they see as speculative excess and they are cracking down hard. Below is the title of a Bloomberg article on the crackdown – link.

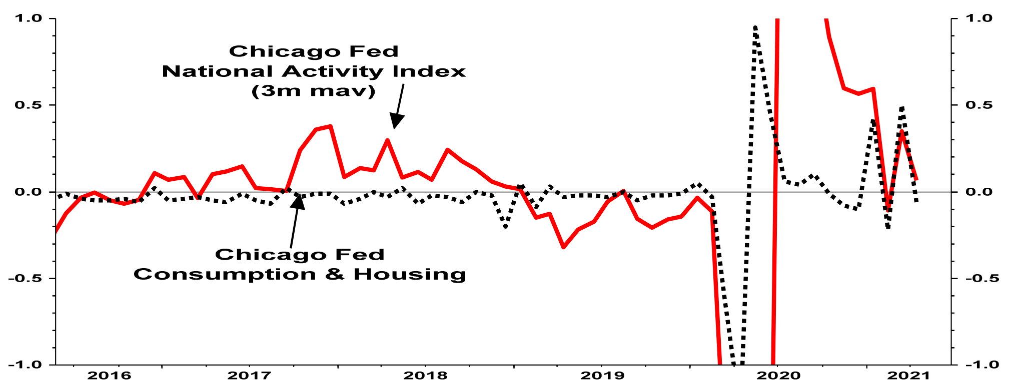
"China Targets 'Speculators and Hoarders' to Stop Commodity Boom"



Source: Bloomberg

Like China, most recent data suggest the US economy isn't booming either. The Chicago Fed National Activity Index aggregates 85 indicators of growth - a reading of zero for the 3-month moving average is regarded as the economy growing close to the 2% trend (see red line below).

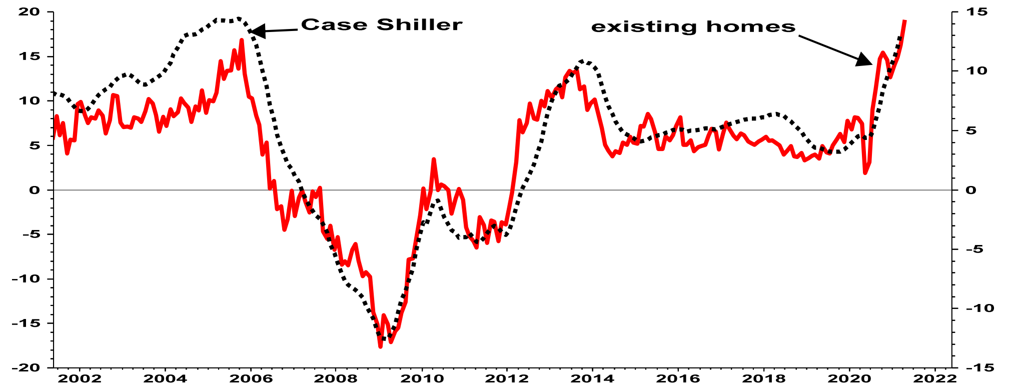
The US economy may not be as robust as many people think - especially housing and consumption



Source: Datastream

Given the recent gangbuster US housing and consumption data, the decline in the Chicago Fed measure back below zero might come as a surprise (see dotted line in chart above), especially when one looks at the current house price bubble (what another one?!).

Current US house price inflation exceeds that seen prior to the 2007 collapse on some measures



Source: Datastream

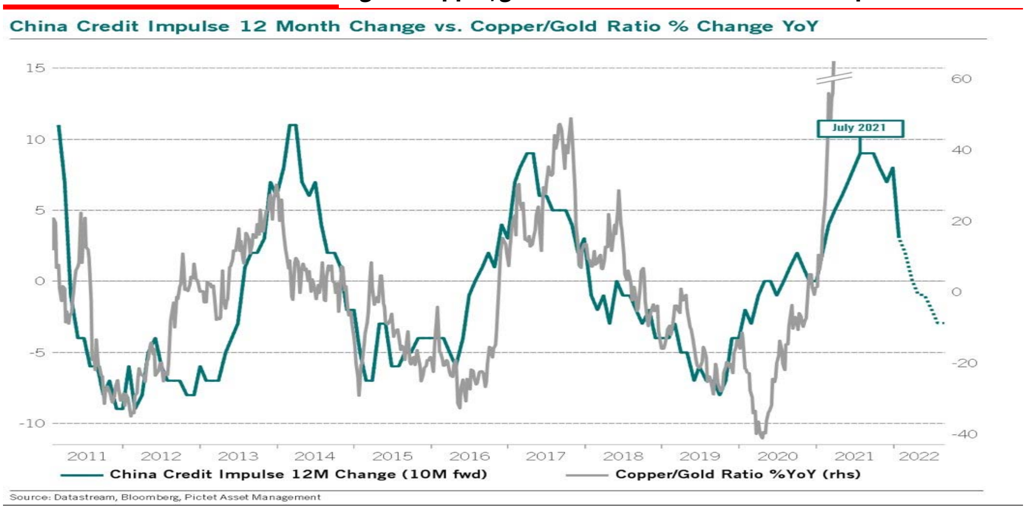
But while US homebuilders are partying as prices soar, US buyers are as downbeat as they ever have been. High prices and rising mortgage rates may have prompted a buyers' strike -link!

Homebuyer confidence seems to lead homebuilder confidence

Source: Zero Hedge

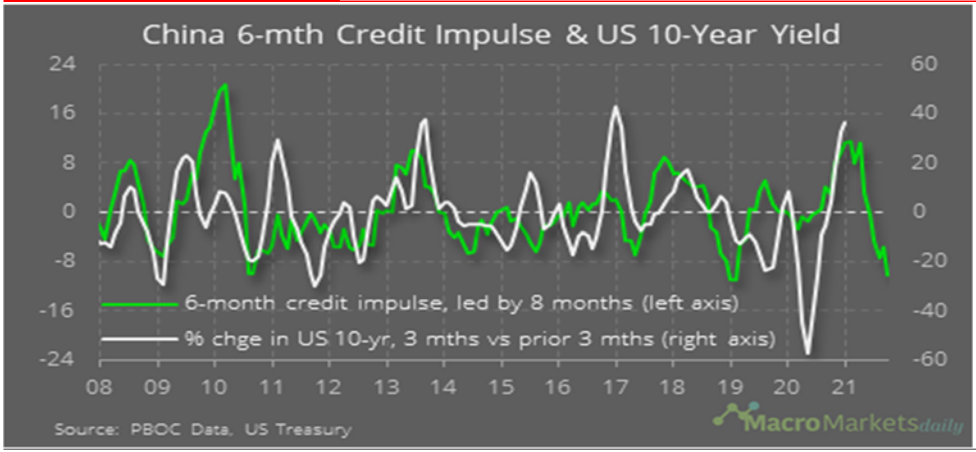
So despite the euphoric optimism about the strength of the global economic cycle and its inflationary implications, investors may be in for a major cyclical shock – relative to expectations.

Another chart from Pictet showing the copper/gold ratio and the China Credit Impulse



Source: Pictet Asset Management

The charts from Pictet's Julien Bittel above show the 12-month change in credit growth – known as the credit impulse. We showed the chart below from Macro Markets last week. They prefer to look at the 6-month change and they note that it leads the performance of many macro trades such as US Treasuries (see below and @macro_daily on Twitter for various charts).



Source: Macro Markets Daily

While so many investors are focused on President Biden's super-loose (some would say crazily loose) fiscal stance in the US, they are missing the deflationary impulse heading down the tracks from China. Our own China expert has just published a comprehensive slide-show round-up on the China economic conjuncture - definitely worth a look given the current situation – link.

If sentiment is set to turn, what technical road signs should we be looking out for? Actually we have just driven past one. One key indicator of a change in price momentum worth watching is the MACD (Moving Average Convergence Divergence indicator – see here for further explanation and calculation link). The *weekly* 30y T-Bond MACD (and indeed 10y T-Note) has just broken upwards (red circle below) for the first time since May last year – when 10y yields were down at 0.6%. This suggests that the momentum headwind the US bond market has been struggling against for over a year has turned into a tailwind. The winds of change have indeed changed.

US 30y T-bond weekly MACD has just broken upwards

Source: Reuters Eikon