Global Strategy Weekly

Inflation trade at breaking point

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The unravelling of the inflation/reflation trade has accelerated over the past week. US 10y bond yields continue to decline and have now broken a crucial technical level. This could see the rally accelerate sharply, and with it, the continued unravelling of cyclicals and commodities.

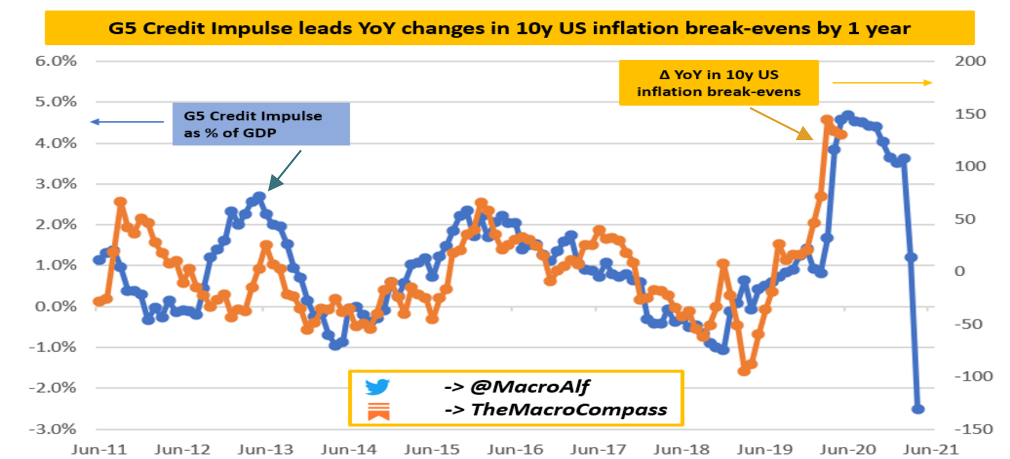
- I absolutely still believe that during the course of this economic cycle, we have begun to move away from The Ice Age secular theme into what I have dubbed The Great Melt (OK I know it sounds like a giant Swiss fondue but it is also the title of a BBC David Attenborough documentary – link).

- I believe that the pandemic recession has allowed policymakers to cross the Rubicon of fiscal rectitude to a reach a new land – one where their existing monetary profligacy can now be coupled with fiscal debauchery. At a political level I do not believe there is any turning back now the sweet fruits of monetary-funded fiscal largesse have been plucked and tasted. Any government which attempts post-GFC style austerity will be cast into the electoral wilderness.

- In that respect I am very much in the inflation/reflation camp. But I think it is a secular theme that will play out later in this cycle. The problem is the markets have been too early in betting on the reflation trade and are now set up for a huge disappointment.

- In that sense I am very much still in the David Rosenberg camp for the next 12 months or so. I think the rise in inflation expectations over the past year will fully reverse, as shown in the chart below. Twitter is such a great source of macro-ideas and I spotted that @AndreasDagasan had used the chart below in his *Citiwire Pulse* document - link. The chart was originally produced by Alfonso Peccatiello whose *Macro Compass* you can find on Substack or Twitter as @MacroAlf. His point is the same as the one we have been banging on about for weeks with regard to the China Credit Impulse. It is the second derivative of the stock of credit that drives economic growth – ie the ***change in the credit growth rate***. In the chart below Alfonso shows *the change* in US 10y breakeven inflation on the right-hand axis. Similarly, it is not the *absolute* size of a fiscal deficit that drives GDP growth, but ***the change in the size of the deficit***. And in that respect the OECD calculates that the US is set to face a hurricane force headwind (see inside)!

The CHANGE in credit growth drives the CHANGE in inflation expectations *



*Inflation break-evens lagged by 1yr. Source: Macro Compass, Alfonso Peccatiello

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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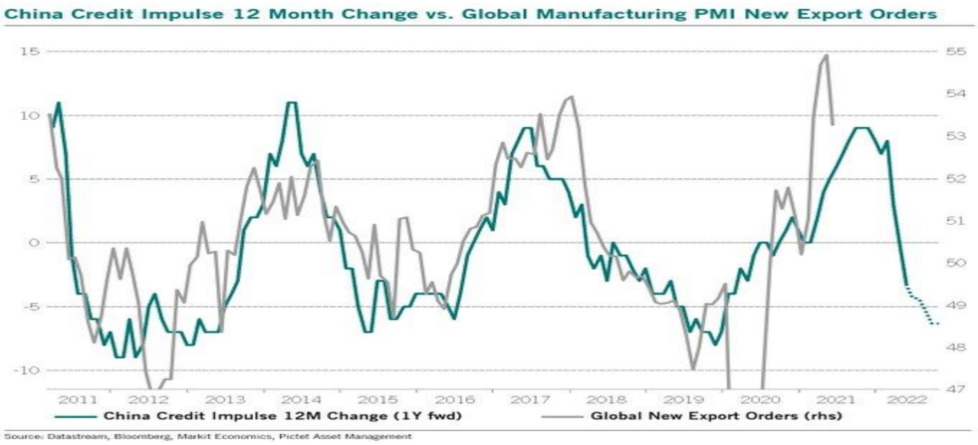
The chart on the front cover is very similar to the one we have been highlighting for some weeks in its various forms that shows the rapid slowdown in the Chinese Credit Impulse and the implications. The chart below from @BittelJulien is just one of many we have shown to warn clients what might be heading down the tracks.



No wonder the US bond market has been rallying hard this past week. The long bull market looks entirely intact and with yields falling below 1.3%, a critical technical hurdle has been jumped.

The Ice Age secular decline in US 10y yields is still very much alive

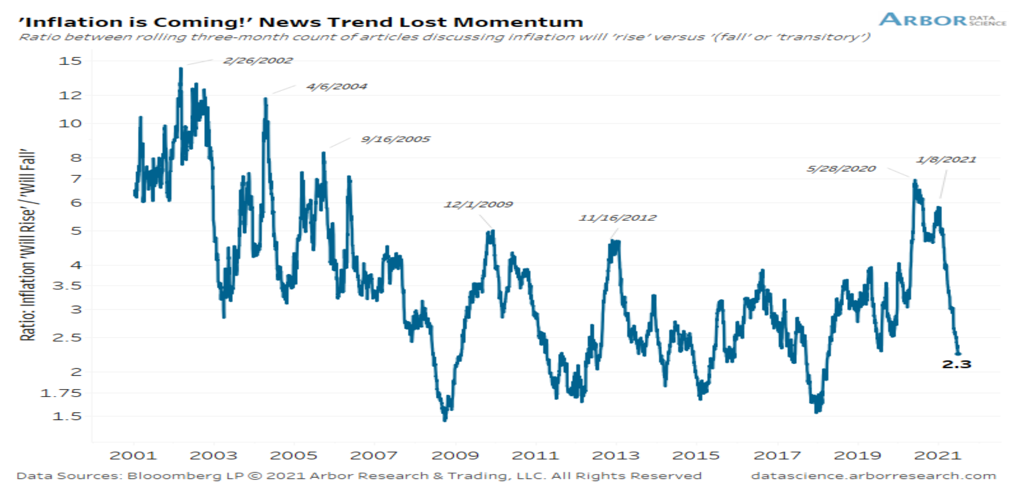
Source: Eikon Reuters

This chart below is clearer. *Today* the US 10y has broken well below1.30%, well below the double-bottom low of 1.32%. A chartist would look at this chart and say that the 0.5% low now beckons.

US 10y has broken critical support – this could trigger a rapid decline to test the 0.5% low

Source: Eikon Reuters

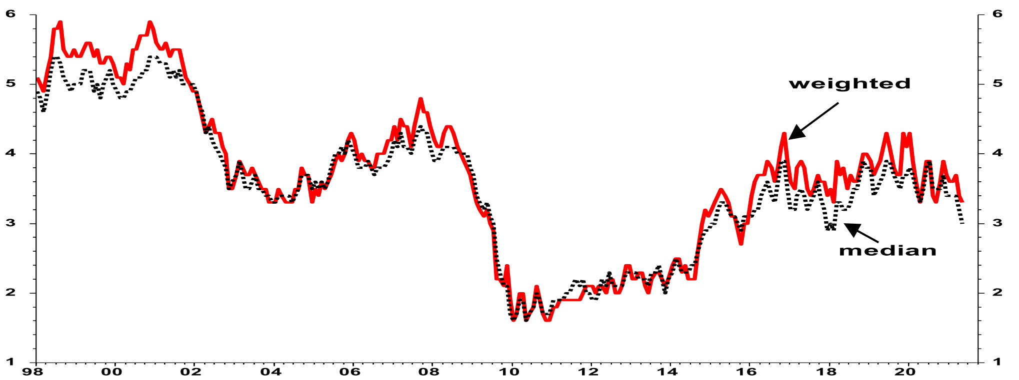
It's not just in the bond market or equity sector performance where we can see the inflation trade rapidly unwinding. @DataArbor show that the ratio of articles discussing higher inflation versus lower/transitory inflation has collapsed from its recent peak.



Source: @DataArbor, Twitter

Market fears about inflation being more than a just transitory event centre on whether wages take off in the face of companies reporting extreme labour shortages. Yet instead, the mix-adjusted wage measure from the Atlanta Fed suggests wage inflation is actually falling, not rising!

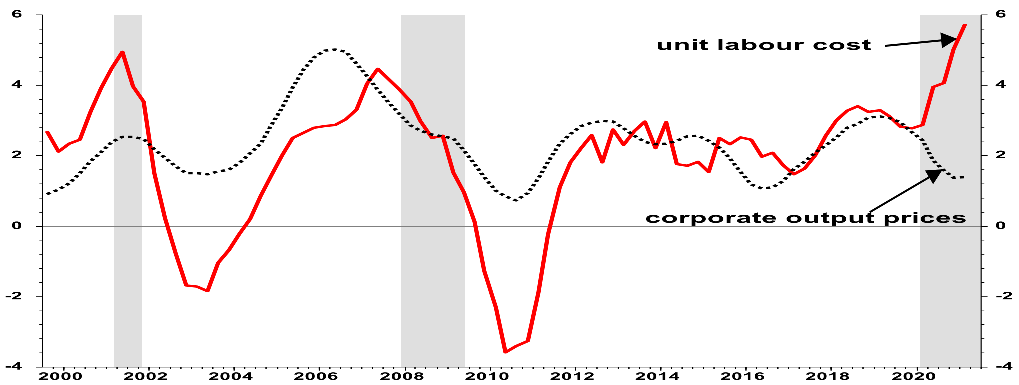
The Atlanta Fed is one of the few US wage inflation measures that is properly mix-adjusted



Source: Datastream

But if there is one chart that does concern me it is that below. Combining productivity growth with wages, *unit* labour costs are the principal driver of corporate costs. We remain watchful but sanguine, because in the wake of every single recession, unit labour costs plunge, driving core inflation sharply lower. I see no reason why this time will be different – but I remain watchful.

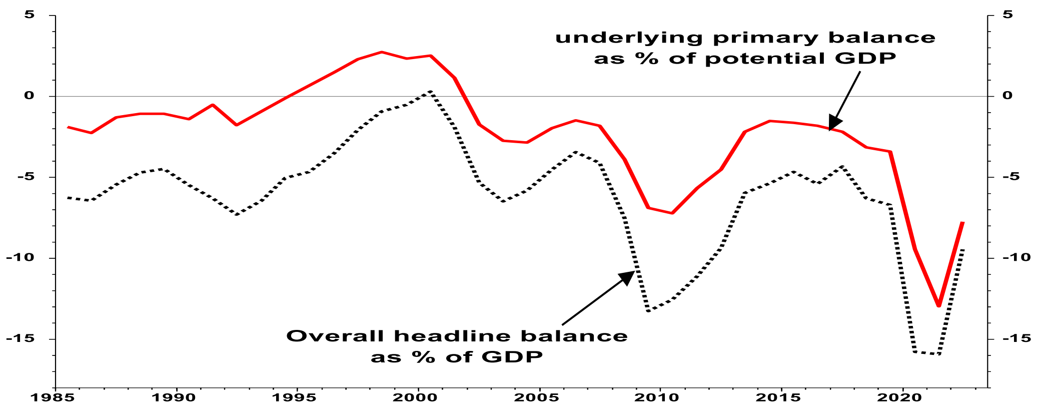
US Unit Labour Costs roaring ahead (6 quarter % ch of smoothed 4q mav)



Source: Datastream

Let's return to the point I made on the front page about it being the CHANGE in credit growth or the CHANGE in the underlying (ie cyclically adjusted) fiscal deficit that drives GDP growth, etc. We show below the massive US fiscal deficit in contrast to the more moderate European ones.

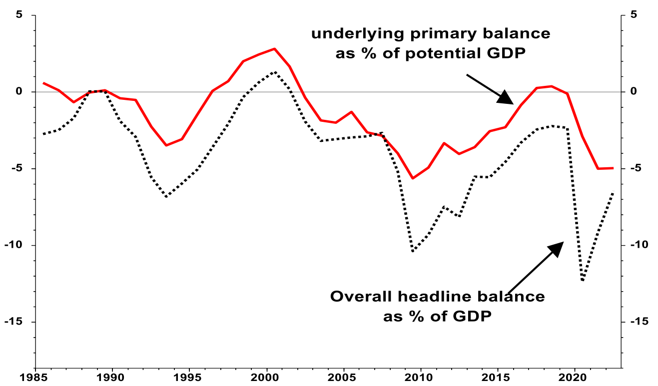
US fiscal deficit/surplus: headline and underlying, cyclically adjusted



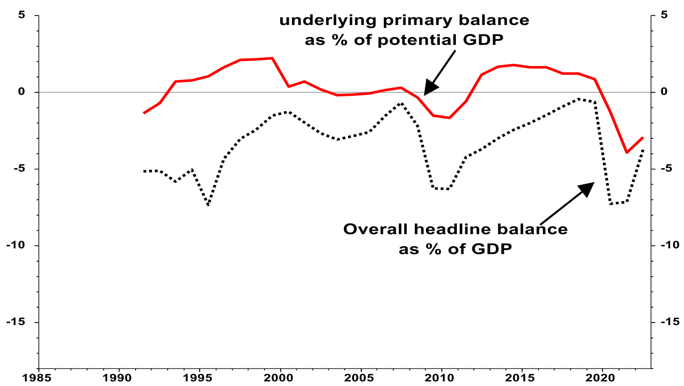
Source: Datastream

All deficit calculations for the charts on this page are from the OECD and include a 2022 forecast. Clearly with the pandemic it is unusually difficult to calculate the cyclically adjusted deficit, but the OECD is well equipped to take a good stab at it. Below we show the UK and eurozone using the same scale as the US deficit chart above - emphasising just how outsized the US deficit is.

UK public sector deficit/surplus



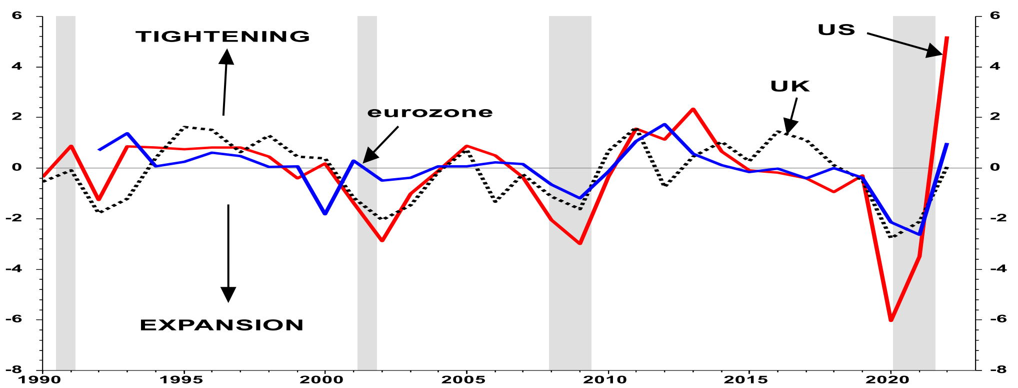
Eurozone public sector deficit/surplus



Source: Datastream

The OECD expect all headline deficits to shrink sharply, but the US stands alone in facing an unprecedented discretionary fiscal tightening (of around 5% of GDP) despite the headline deficit staying at a high 10% of GDP. That tightening begins to unfold as we progress through the rest of 2021. Like the front cover chart, this suggests the inflation trade has a long way to unwind yet.

The CHANGE in the underlying cyclically adjusted fiscal deficit is a MASSIVE headwind for the US



Source: Datastream