thenavigator

Summer 2021

"INFLATION IS AS VIOLENT AS A MUGGER, AS FRIGHTENING AS AN ARMED ROBBER AND AS DEADLY AS A HIT MAN." *Ronald Reagan (1978)*

IF YOU THOUGHT THE EUROPEAN SUMMER WEATHER WAS CHANGEABLE, JUST WAIT UNTIL YOU SEE THE MARKETS!

There has been an inordinate amount of nonsense talked about in the markets since the advent of 24/7, 365 days a year financial coverage. From my rather no-nonsense and pragmatic perspective, it often seems as if people revel in making things unnecessarily complicated but also on a regular basis just making up the narrative to fit the market movements, quite often contradicting their own previous comments from just days before.
A prime example is the recent decline in the 10-year US Treasury bond yield from 1.75% to around 1.15%, which has prompted many market observers to come up with all sorts of interesting theories. But might this story actually be fairly simple? With so many people all positioned the same way for US Treasury yields to rise, it wasn't going to take much to move the needle the other way as investors with leverage quickly found themselves on the wrong side of the trade. Quarterly rebalancing by pension funds following the strong equity performance alongside purchases of US Treasuries by overseas investors whose domestic bonds have negative yields are also likely contributors to the decline in yields, despite higher-than-expected inflation readings.
These factors are somewhat technical, and I fully expect US 10-year Treasury yields to finish the year at around the 2% level. To put this into perspective, the last time inflation readings were this high, the Fed funds rate was at 4.75% and the 10-year US Treasury was yielding over 7%.[1] This move will no doubt lead to some excitement in the second half of the year.

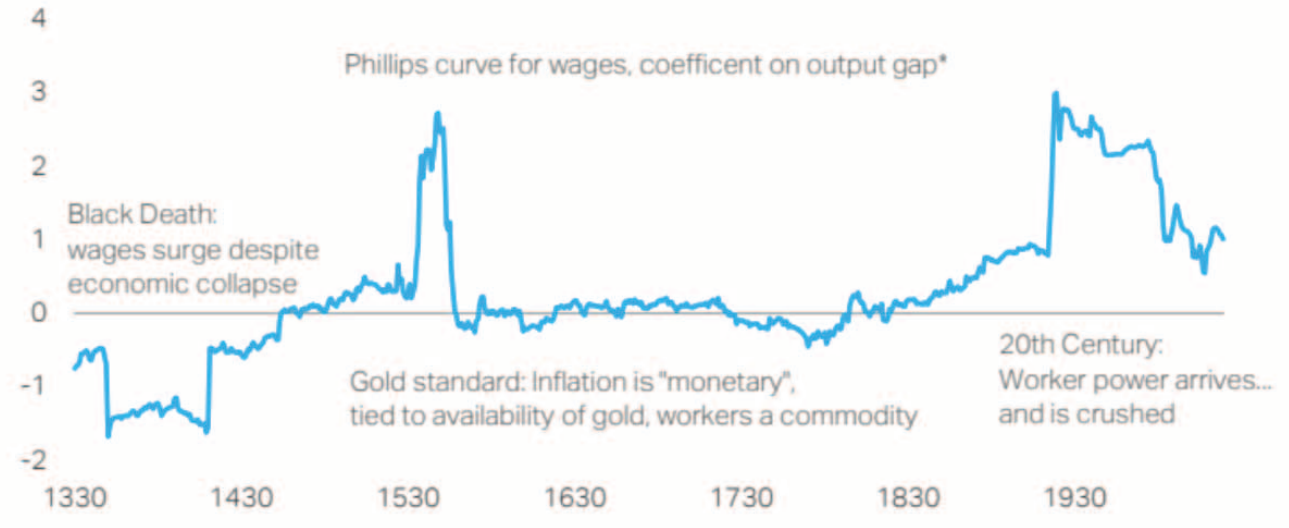
STOP THE GAMBLING

Another major contributor to the enhanced volatility which I expect in the second half of the year is the overall make-up of the market. The advent of ETFs with and without leverage, stimulus cheques and excess liquidity means that many financial markets have turned into the equivalent of sports betting, where people are able to place their bets quickly and cheaply without much in the way of a thought process. The overall market make-up, with the vast majority of people never having witnessed inflation and ensconced in a belief in permanent deflation, could also contribute to gut-wrenching volatility.

"A JOB IS ABOUT A LOT MORE THAN A PAYCHECK. IT'S ABOUT DIGNITY. IT'S ABOUT RESPECT. IT'S ABOUT BEING ABLE TO LOOK YOUR KID IN THE EYE AND SAY EVERYTHING WILL BE OKAY. TOO MANY PEOPLE TODAY CAN'T DO THAT – AND IT'S GOT TO CHANGE." *Joe Biden (2021)*

One of the thoughts I have had recently is that we are witnessing a secular change to the neoliberal order we have seen over the last 40 years. Central banks, led by the US Federal reserve, are now working in conjunction with governments to try and bring about a fairer society.

Worker power emerged in the 20th century – then neoliberalism crushed it



Source: Bank of England database, TS Lombard estimates, *50-year rolling coefficient

Some historical context

Source: Bank of England, TS Lombard

Neoliberal inequality

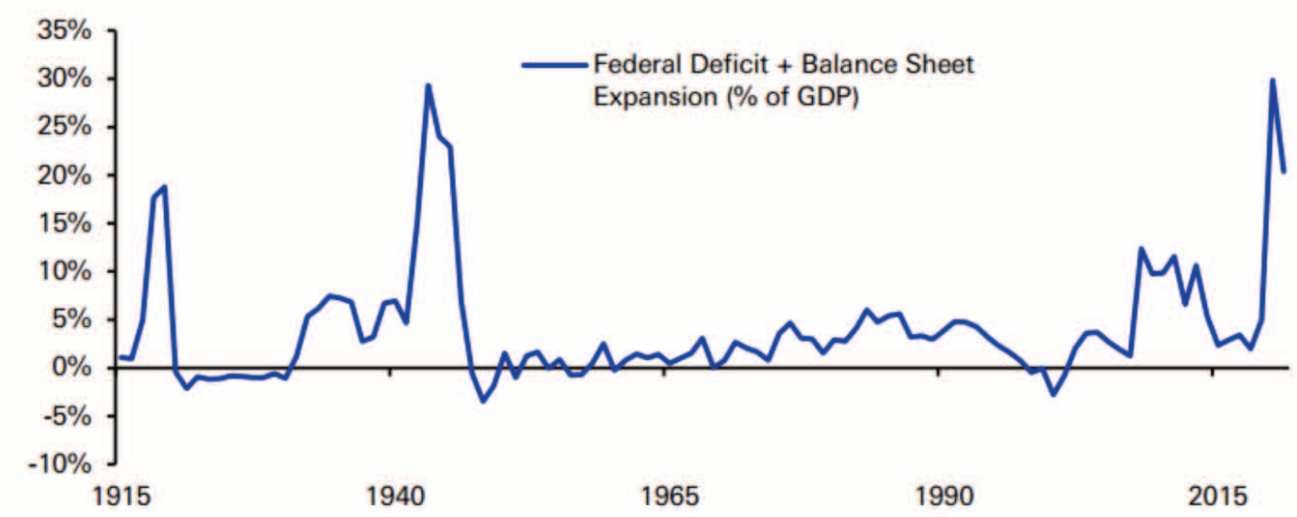
Source: Piketty Inequality Database

While some people are talking about us being at a mid or even late stage in the economic cycle, I really think these commentators need to get out more.
Everywhere I have travelled in Europe I have seen nothing but people enjoying themselves without a thought for the cost or the weather. Is it really possible that in just a few months people could have made up for all the activities they had planned but had to forego?
I get the same feedback from clients all across the world who tell me they are seeing an economic boom driven by pent-up demand, high savings rates and animal spirits.
Economic growth in developed markets is likely to be at levels we have not seen for decades, with the US economy growing 7% this year and then 5% next year. Europe, meanwhile, is expected to grow by 5% this year.[2]
I would not be surprised if there is actually upside to both numbers. Amidst such strong economic activity, it is only reasonable and logical to expect higher inflation as well.
The recent reversal in the reflation trade (companies that benefit from increased economic activity) is also likely to re-establish itself, adding to the fun as people find themselves on the wrong side of the market.
Which brings us very neatly to what is perhaps the biggest risk in the markets.

AN UNFORCED POLICY ERROR BY CENTRAL BANKS

Central banks are effectively walking a high wire above an abyss filled with crocodiles – none more so than the US Federal Reserve. It will require some nimble footwork and fine balancing to avoid a fatal accident. The good news is that there is still some time left. That said, the window is narrowing.
While it is highly commendable for central banks to let economies run hot in order to make up for lost output during the pandemic and also for the years when economies were not growing, there is a very real danger that inflation could get out of control, with economic growth going supernova and the central banks ultimately hurting the very people they are trying to help – those at the lower end of the income scale who are more exposed to inflationary pressures.

US fiscal and monetary policy has not been this coordinated since WW2



Source : GFD, Deutsche Bank

While I do not believe that inflation numbers will continue at the same velocity we have seen recently, we should be prepared for a higher final level of inflation over the longer term (let's call it 3.5%). In return, however, we are likely to experience higher economic growth rates than we have seen over the last decade.

After all, why would workers accept lower wages if the job market remains tight and their cost of living has gone up?
If supply chains are facing challenges now with only part of the world economy getting back to normal, why would they ease when the rest of the world starts opening up?

Source: University of Michigan survey

The increased inflation expectations on the part of consumers are in themselves inflationary. After all, if you think the price of an item is going to get more expensive, why delay your purchase? This could in turn lead to quicker restocking of inventory levels by businesses.
If (as I suspect) we continue to see fiscal stimulus by governments and inflation numbers remain robust towards year-end, the Federal Reserve is likely to quietly and methodically start reducing its purchases of government bonds (tapering) and – towards the end of next year – slowly but surely start to increase interest rates. This will ensure that we don't just break out of the last decade's deflationary spiral and financial repression, but also that the recovery will be enduring and will avoid the previous cycles of boom and bust. Surely this must be the noblest calling for any central banker?

The Navigator
has been written by:
Peter Ahluwalia, Partner
Chief Investment Officer

[1] https://www.bloomberg.com/opinion/articles/2021-07-14/inflation-shock-it-s-time-for-fed-to-consider-evasive-action
[2] https://apnews.com/article/joe-biden-business-health-coronavirus-pandemic-7604c261155eef095e94bb644aae99c4

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