Trend Macro™

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MACROCOSM

It's Just the Reflation Trade, People!

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Donald Luskin

Overdue and inevitable. The animal spirits driving the bond back-up is all good for stocks.

Trump was right, apparently: "We will have so much winning if I get elected that you may get bored with winning." Which is only a way of saying that after the sustained low-volatility global equity rally since the 2016 election, a shocking correction was inevitable – and long overdue. It may not need all that much more explaining than that. And despite the cognitive bias that compels us to believe that the fire and fury of it indicates it will continue, the further stocks have fallen, then the less they have yet to fall.

We'd been on correction-watch for two weeks, but it came with a vengeance last week *slightly before* the indicator we said we'd watch most closely – the S&P 500 equity risk premium – gave its sell-signal (see "A Year of Upgrades in 16 Days" January 16, 2018). Throughout the spectacular rally of the last several months, especially since the Tax Cuts and Jobs Act was enacted in mid-December, the ERP never quite narrowed further than its prior post-crisis tight observed last March (which was the occasion for the only other 3%-plus correction since the election).

We think there's little sense in the prevailing narrative that equities face "existential questions" from the "menace" of a "drastic run-up in yields," or that investors are "shocked" by a sudden return of inflation. Neither is new (please see the chart below), *neither is unexpected* (see "2018 Outlook: From Denial to Acceptance" December 29, 2017) *and neither is bad.*

Update to strategic view

US STOCKS, US BONDS, US FED, US MACRO: It was time for some volatility in stocks, and we got it in spades – and a little bit sooner than we had expected. Higher long-term yields are a popular but wrong explanation. The present back-up has been underway for a year-and-a-half, and signals the revival of animal spirits and some progress toward healthy levels of inflation. The back-up in the forward funds rate only brings the market in line with long-standing "dot plots." The Treasury issuance…

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Source: Bloomberg, TrendMacro calculations

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Yes, higher long-term yields contributed to the ERP's narrowing, last March and now. As a short-term mechanical measure of relative valuation, that matters – but strategically it fails to capture the salutary generational turning toward risk-tolerance and animal spirits that is animating a synchronized bull move in stocks and a bear move in bonds. This is a seemingly valuation-defying intermarket dynamic that we have seen again and again over many years – indeed, in 18 out of 21 episodes of major yield back-ups since 1946 (please see the chart below and, most recently, "On the January Jobs Report, and the Yield Back-Up" February 2, 2018).

- The post-Great Recession world of so-called secular stagnation has been marked by low long-term yields that were emblematic of extreme risk-aversion and safe-haven demand. In the depths of the panic after the Brexit referendum, the US Treasury 10-year traded at 1.32%, the lowest yield in the history of the United States of America. *The back up in yields since then has been a blessed recovery from that pathological state* (again, please see the chart on the previous page).
- We called the bottom then, arguing that Brexit was a breath of pro-growth global animal spirits (see "Brexit: Who Won, Who Lost, What's Next?" July 11, 2016).
- We doubled down after the surprise election of Donald J. Trump, which triggered another big back-up, citing the same reason (see "Trump and the 'Reflation Trade'" November 15, 2016).
- Believe it or not at this nervous moment, just a couple months ago investors were worried about *falling* yields, thinking they indicated

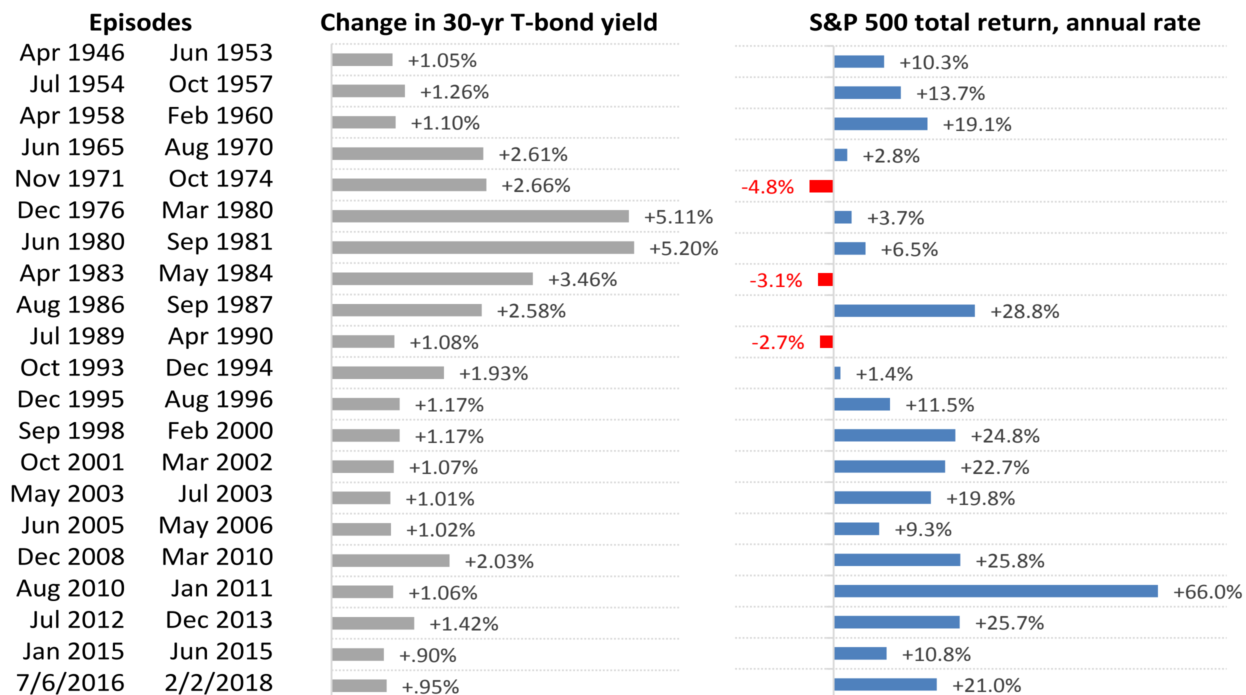
Update to strategic view

Continued from first page

…calendar is heavy, but there is no empirical evidence for a relation between net borrowing and yields. Historically, yield back-ups have been associated with higher equity prices. We have no reason to think that this one will play out any differently.

[Strategy dashboard]

Relation of major back-ups in bond yields to stock market returns



Source: Bloomberg, TrendMacro calculations

the Trump reflation trade was over, and fretting that a flattering yield curve meant recession was just over the horizon. We called the bottom then, at 2.01% on the 10-year, when Trump made a deal with Charles Schumer (D-NY) and Nancy Pelosi (D-CA) to temporarily suspend the debt ceiling (see "Debt! NoKo! Irma! DACA! Cohn! …and Other 4-letter Words" September 7, 2017). We argued this would clear the legislative agenda and enable the GOP to ram through a corporate tax cut (against a virtually unanimous consensus to the contrary), giving another big dose of animal spirits, and another leg up for yields.

- So here we are. Yields are higher – but still not even close to prohibitively high, in any historical context – and the yield-curve has steepened somewhat – and it is called an "existential" "menace."
- *It's not persuasive to argue that the post-September back-up in yields is a "menace" because it is supported by a dangerous increase in inflation expectations.* Of the 79 bp back-up in the 10-year yield since the September bottom at 2.01, the majority – 46 bp – has come from the growth-sensitive term premium, with only 33 bp coming from the inflation-compensation component.
- Is 33 bp still too much? It takes the TIPS breakeven spread to 2.14%, which is indeed slightly above the Fed's target of 2%. But the Fed believes the Consumer Price Index, on which TIPS inflation compensation is calculated, *overstates* inflation by about 50 bp.
- Most important, don't forget that the seemingly inexplicable shortfall of inflation for most of the past decade – against some very heavy lifting by the Fed and other central banks – has been further evidence of economic pathology, the recovery from which we should welcome. By most standards, at this point, a little more inflation would be good – and there's really no reason to expect that a little more would metastasize into too much.
- *We also think it's not persuasive to argue that the real threat underlying the back-up in yields is what it implies for sharply more aggressive Fed policy.*
- For one thing, we think that if the Fed were really expected to be tighter, long-term yields would fall – because both growth expectations and inflation expectations would fall (see "Bull Market, Meet Your New Fed" January 29, 2018). So we think a tighter Fed simply doesn't explain that which it is adduced to explain.
- To be sure, the curve implied 1-year forward funds rate has backed up by a seemingly impressive 29 bp – more than a whole rate hike – since the December FOMC. But at 2.12, that's only what the "dot plot" had already predicted at that same meeting for year-end 2018 (see "Data Insights: Federal Reserve" December 13, 2017).
- We won't be surprised at all to see the FOMC slightly upgrade its "longer-run" dots at the March meeting, positing a higher equilibrium funds rate (see "On the January FOMC" January 31, 2018). But this will only reflect a tentatively more hopeful view of the growth potential for the economy in a steady-state – so it would be a fundamental error to infer that the Fed expects policy to be any tighter. Remember, the equilibrium funds rate – by definition – is a "neutral" funds rate, so raising it (or, for that matter lowering it), says nothing about policy and everything about the FOMC's

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Recommended Reading

We're allowed to enjoy a movie
Renee Graham
Boston Globe
February 2, 2018

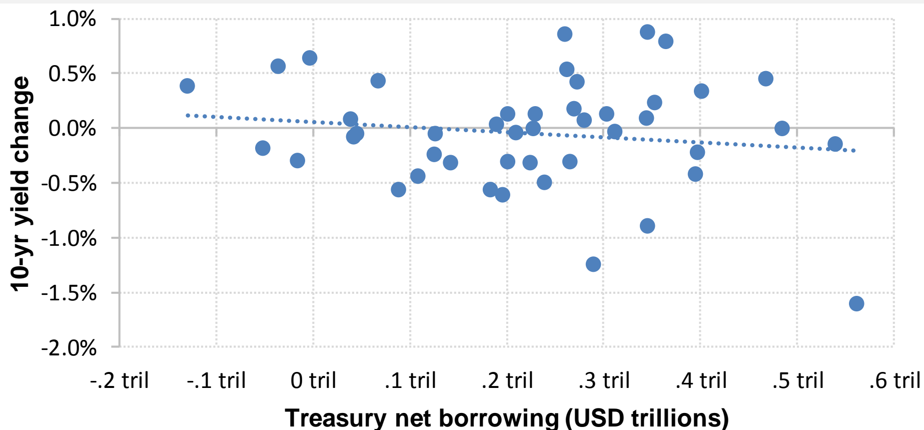
The Trump Growth Machine
Richard A. Epstein
Defining Ideas
January 29, 2018

[Reading home]

appraisal of the underlying economy.

- *We have also considered a possibility raised by a client on Friday: that the back-up in yields reflects the unusually heavy $441 billion Treasury issuance calendar during this quarter*, and therefore signals a tightening of financial conditions as the government's funding needs suck capital out of the economy. We can't rule out that this factor might be pushing yields higher – it's impossible to rigorously relate prices to trade-flows. We do know, simply as an empirical matter, there has been almost no detectible relation between the Treasury's borrowing volume and prevailing yields, indeed it's been slightly inverse (please see the chart below).

Relation of 10-year yield and Treasury net borrowing Quarters from Q3-06



Source: Bloomberg, TrendMacro calculations

- *Finally, let us repeat what we said at the outset, and many times before: so long as higher long-term yields signal a salutary return to healthy levels of inflation, and signal more robust growth expectations, a back-up is consistent with higher equity prices – as has been demonstrated in 18 of the 21 large-scale back-ups that have occurred since 1946* (again, please see the chart on page 2). *We have no reason to think that this one will play out any differently.*

Bottom line

It was time for some volatility in stocks, and we got it in spades – and a little bit sooner than we had expected. Higher long-term yields are a popular but wrong explanation. The present back-up has been underway for a year-and-a-half, and signals the revival of animal spirits and some progress toward healthy levels of inflation. The back-up in the forward funds rate only brings the market in line with long-standing "dot plots." The Treasury issuance calendar is heavy, but there is no empirical evidence for a relation between net borrowing and yields. Historically, yield back-ups have been associated with higher equity prices. We have no reason to think this one will play out any differently.