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The Taper Tantrum – More in Store?

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Speed Read: A classic domestic expansion in the US (better housing, credit and capex) means domestic inflation will spend a 7th year in positive territory. With growth and inflation in Japan and parts of the euro area improving, and the hard landing in China's manufacturing sector and parts of EM behind us, **the external drag on US growth and inflation has already started to ease.** Both will support **higher US inflation and yields.** USD strength imported deflation into the US (from Japan, Europe in 2014, China, EM in 2015) but with no external deflationary shock to amplify right now, **a stronger dollar will not push growth, inflation and yields lower as it did in the recent past. Won't central banks act? The Fed** responds to market prices quite late, only when it is clear that prices have outstripped fundamentals. By contrast, **the BoJ** is targeting 10-year yields, so that any pickup in breakevens will be countered by declines in the real yield – the BoJ would love it.

Market implications: UST yields to rise to around 3% in 9-12 months, German nominal yields, Japanese breakevens to rise, but by less; US equity markets to be led by banks; US dollar stronger, USDJPY higher.

Our next note – the impact on EM: External vulnerability, credit, structural transitions to new growth models.

Never let the truth get in the way of a good story – Mark Twain

Last summer was a watershed moment for our view of the world. The hard landing of China's manufacturing, the adjustment of broken growth models in EM, and the consistent improvement in the domestic side of DM economies had a lot to do with that. We warned against the secular stagnation view of key advanced economies, changed our 2012 bearish EM call to signal a gradual turnaround in EM, and anticipated a stabilization in China...

...and we warned that markets were underestimating inflation.

By this summer, we thought DM output gaps would be closed, or be much tighter, while the drag from China and EM would abate. Together they would push inflation higher. But now that inflation is here and yields have shot up, there are three further questions to answer.

1. Inflation – are both domestic and external drivers pointing upwards?

Domestically, Secular Stagnation is a great story... Secular Stagnation (SecStag henceforth) doesn't just mean low growth. Rather, it is a very specific narrative: Excess capacity in the economy generates deflationary pressures, which in turn don't allow the real interest rate to fall low enough to stimulate weak demand. Particularly because the equilibrium real rate has fallen, monetary policy isn't expansionary enough and the economy stagnates for years.

...but the facts don't fit the story Domestically generated growth and inflation in the US, Japan, Germany and the UK are simply not in sync with the SecSag story – peruse our chartbook on page 4 for evidence.

- *Slack is dwindling rapidly:* By the OECDs measure, there is still an output gap in the US, but it will have shrunk by *over 2%* of GDP between 2014 and 2017. To boot, the services sector that makes up 90% of GDP and 75% of value added is doing much better and probably shows very little slack by now, if any. Yes, the US labour market is probably not as tight as the unemployment rate suggests – people working part-time because they can't find full-time employment are still a sizeable number. But even in the labour market, most of the damage has been in the externally exposed sectors, not in the domestically oriented ones. And the unemployment rate *is* 4.9%. Slack is dwindling elsewhere too. The output gap has closed in the UK, and is positive in Germany and Japan. Labour markets? Tight in all four economies!! Exhibit 5.
- *Deflation? What deflation?* Domestically generated inflation (services ex-healthcare) in the US has been solidly sequentially positive since *2009*, and has picked up even a bit more since 2015. It is imported goods deflation, amplified the last few years by a stronger US dollar, that has pushed overall inflation lower. In Japan, inflation is clearly weakest, but do remember Governor Kuroda's point that domestically generated inflation was doing rather well while commodity prices were dragging overall inflation lower in 2015. The Bank of England expects inflation to hit 4% next year, and Germany is chugging along well ahead of the euro area on core, headline and wage inflation.

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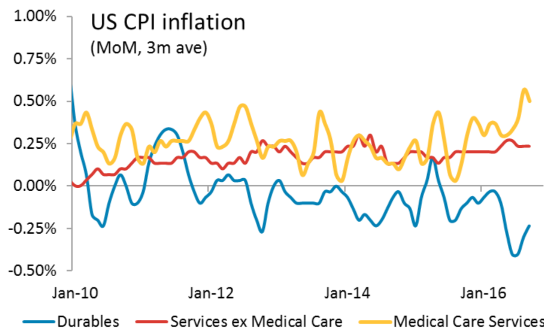
- *That means more, not less, monetary stimulus for the already-healthy services sector* The real interest rate (= nominal – inflation) for the resilient housing, services sectors has been *negative* (exhibit 8) and is *falling further*, but high and rising for the beleaguered manufacturing sector. Talk about procylical policy!

Externally, the structural inflection in China's growth means a smaller drag on EM, and hence in turn on DM China will continue to structurally slow for years to come, but through its services sector, and hence in a way that affects North Asia but not the rest of the world as much (more on that soon). Real industrial production is flat but manufacturing revenues are rising with PPI inflation. China still has excess capacity and will emit deflation again – but will it be the dramatic deflationary shock that engulfed both economies and commodities in the past? Very unlikely.

Fine, but won't USD strength simply dampen this inflation dynamic if appreciation continues? This is like asking someone if traffic on the M1 is going to be heavy. That depends on when you drive. Heavy traffic if we're talking about rush hour, practically none if it's the middle of the night.

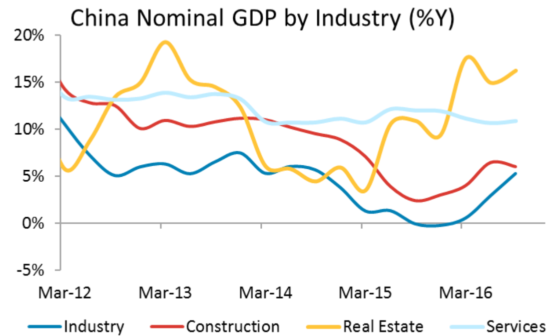
Why is the dollar strengthening? The currency is a relative price and usually reflects a relative growth (or return) differential. USD strength reflected weakness in Japan and Europe in 2014, and in China and EM in 2015. USD strength on both occasions amplified this negative external shock. Today, USD strength reflects better growth prospects for the US economy while the rest of the world is doing all right as well. Put another way, USD strength in the 2014/15 episodes slowed down growth and inflation and pulled yields lower because it was amplifying and external deflationary shock. If there is no external shock on the horizon to amplify, there is little reason to believe that the impact of a stronger US dollar will be anything like episodes of the recent past. Unless the external backdrop changes, and a deflationary shock materialize, last year's playbook isn't that useful.

Exhibit 1: **Domestic Pick-Up, External Drag Down**



Source: Bureau of Labor Statistics, Talking Heads Macro

Exhibit 2: **Stability after the (Mfg) Hard Landing**



Source: China National Bureau of Statistics, Talking Heads Macro

2. At long last... an old-fashioned expansion to support inflation, with capex and productivity? A classic expansion is on its way in the US, seven years into the... expansion... wait, that sounds weird... but its right given this most atypical of cycles.

Inflation has three fundamental supports: housing, credit, and capex (really? really!)

- **Housing *is* the business cycle**, so Ed Leamer's pithy insight goes. Even if it doesn't explain everything, it comes close... especially in this cycle. Bill McBride at Calculated Risk argues that housing has further to go. Inventory is low and the housing/GDP ratio (exhibit 7) is still below the lows of past expansions.
- **The 'sweet spot' in credit** A steeper yield curve and a central bank that is just behind the curve makes for a sweet spot for banks (and Dodd-Frank gone?). Expanding credit is likely to be far more profitable.
- **Capex, finally!** Corporates have issued low yielding debt to buy back equity and financially engineer a higher ROE. Capex has suffered. But now (i) the profit recession is over, (ii) the return on investment is likely to prove good enough at a time when the world doesn't look like it's in disastrous shape, and (iii) productivity and politics could both make the corporate landscape more benign (more on that soon too).

Some inflation dampeners are in place too Productivity and a rising labour participation rate could dampen inflation and wage growth, but you would need a very strong pick-up in either/both to depress inflation.

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3. Is there more to come from the Taper Tantrum? Could yields rise further? Yes, and yes. If yields don't go to 3% now, then they will squeeze higher over time, even if the dollar appreciates.

There are 3 factors that will determine what happens from here:

- **First, if the equilibrium rate is positive, or now likely to rise very slowly, then yields could rise further** A zero/negative equilibrium rate means very little monetary space, and hence less room for yields to rise. While Fed Chair Yellen has argued that the equilibrium real rate is probably around zero, the precision of that estimate and whether it will stay there are both open for debate. For example, capex spending may rise, while global inequality has fallen sharply (see Branco Milanovic's work) – these would push excess savings lower and the equilibrium rate higher. Most importantly, if the demographic dividend has lowered the equilibrium real rate since 1980, then the ongoing demographic reversal should at least keep real rates from falling, and will probably start raising them slowly over time.
- **Second, won't central banks act?** It's not what the **Fed** does, but it doesn't do that will matter. Simply put, if the Fed doesn't act, then markets will. As for Fed-speaks, that only kicks in when FOMC members are sure that the rise in yields or the USD has become 'exogenous', i.e., it has exceeded the increase that would be justified by fundamentals. Such intervention, for example, came only in August even though the taper tantrum started in May 2013. By contrast, the **BoJ's** commitment to targeting 10-year yields will mean that higher inflation expectations will raise breakevens but lower real yields if the nominal yield is to stay near zero. USDJPY will strengthen to reflect the wedge between the Fed and the BoJ.
- **Will it be higher yields or a stronger US dollar?** Again, let's do this the right way - let's ask: Is the problem one that needs a change in absolute prices (i.e., yields) or relative prices, and how will the two interact? *In the 2014 and 2015 episodes*, the growth differential between the US and other parts of the world needed a relative price adjustment in response to a deflationary shock. As the USD imported that deflationary shock, lower domestic growth and inflation led to lower yields. *Today*, US growth is set to be of a higher quality, thanks to prospective credit and capex, and that makes it even more attractive than almost every other DM economy, so that an absolute *and* relative price adjustment is required. The reaction of absolute prices to a negative shock is very different (yields and risky asset prices fall) to the reaction to positive dynamics (yields, risky asset price rise). And if the price adjustment via USD strength isn't amplifying a deflationary shock, then higher yields and a strong dollar can co-exist… within reason. More of one with a little less of the other is fine. If they both rip higher, the romance may not last.

Is this really enough to cause a tantrum? It certainly is. Even a modest increase in yields can wreak havoc, especially if the move happens quickly enough. Why?

- The duration of US portfolios has gone up to 8 years, up from 2 last year. That, if anything, shows how little markets expected inflation last year (we had no dearth of pushback on our warning last year).
- When yield levels are low and duration high, a small increase in yields can cause large losses. In grad school, we were taught that 'alligator' bonds (long and low - long duration and low yields) were as dangerous as alligators themselves. Gerard Minack, our ex-colleague, demonstrates this fact extremely well. His calculations suggest that a 1% increase in yields could cause something like an 18% loss in the value of an index that tracks long-dated treasuries. 30 years ago when yield levels were much higher, he calculates, a similar increase in yields would have created single-digit losses.

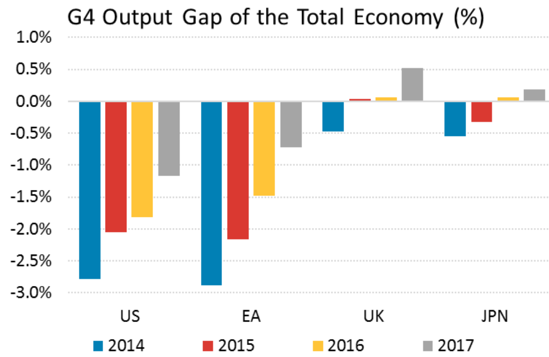
What about the 'triple' part? Will Japan and Europe really 'participate'? Perhaps not actively, but what matters is that they may not drag US yields back down. Growth and inflation in both places stand to benefit more than the US by a stabilization in China, and any upside will mean less of an obstruction to US yields.

When it comes to capturing the beauty in words, characters and stories, Mark Twain is unparalleled. But maybe he took his eloquent phrase too literally when it came to business. A series of poor investments didn't make him a name as an investor. In markets, perhaps it *is* better to have a story that fits the facts.

Better times lie ahead, but so do more risks thanks to higher yields. Years of falling growth, inflation and yields have made portfolios more vulnerable to a reversal. Thankfully, macro trends will produce many opportunities, as long as you stick to the stories that fit the facts. Mr. Twain may have given up much of his fortune to poor investments, but Huckleberry Finn is a treasure he will never lose. The rest of us have to be more careful.

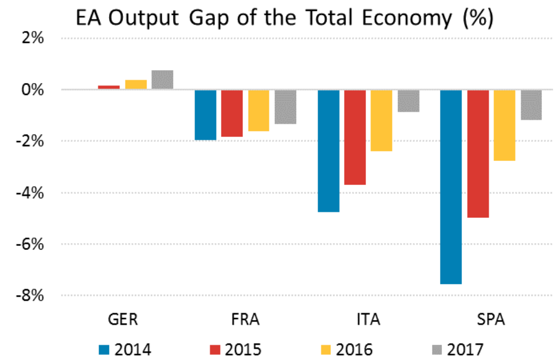
CHARTBOOK: The Taper Tantrum – More in Store?

Exhibit 3: **Output Gaps Closing Fast, or Closed**



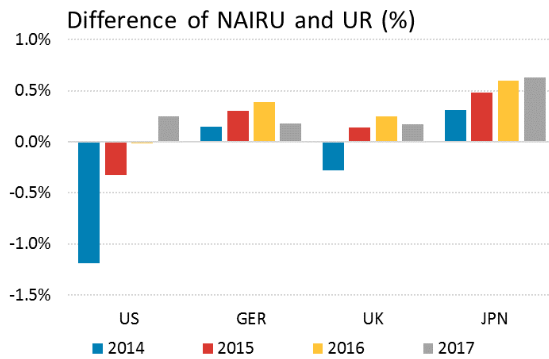
Source: OECD, Talking Heads Macro

Exhibit 4: **Germany – No Slack in Sight**



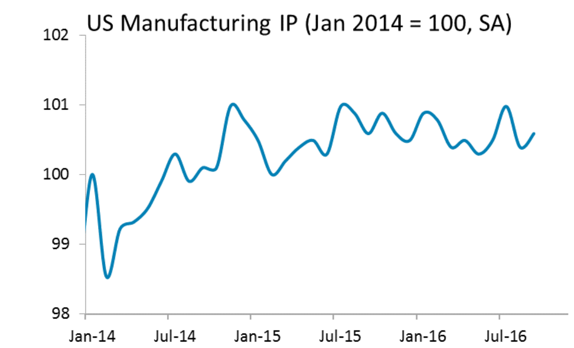
Source: OECD, Talking Heads Macro

Exhibit 5: **Labour Markets are Tight Everywhere!**



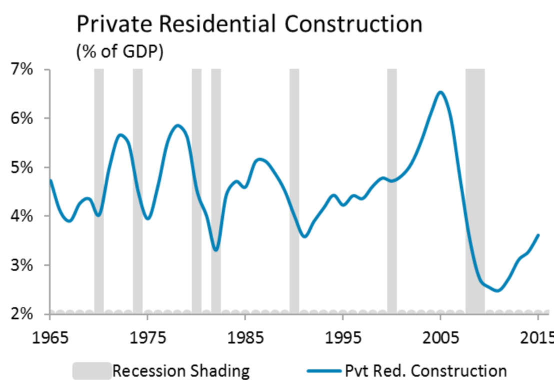
Source: OECD, Talking Heads Macro

Exhibit 6: **Real IP in the US: Stable, set to Rise**



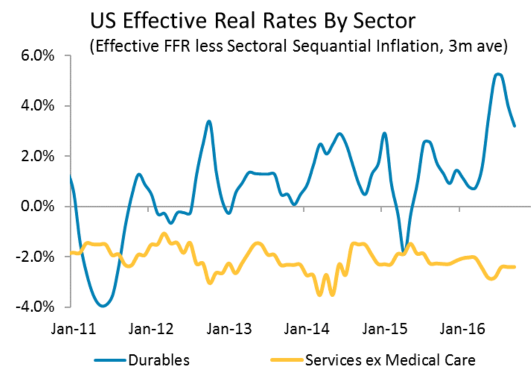
Source: Federal Reserve Board, Talking Heads Macro

Exhibit 7: **US Housing Has further to Go**



Source: Bureau of Economic Analysis, Talking Heads Macro

Exhibit 8: **Real Rates Low where Growth is High**



Source: Bureau of Labor Statistics, Talking Heads Macro

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