ECU

Interview

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The End of 'Deflation Trade'… But No 'Reflation Trade' Just Yet

In this issue:

- **Fed still on track, but bond volatility and overvalued stocks pose risks**
- **'Greek drama' approaching finale: will we see an 'Icelandic-style' default?**
- **As China decelerates, emerging markets and commodities continue to struggle**

1 Highlights for the week ahead

Q Andrew Rozanov

Gentlemen, thank you for joining me for our weekly global macro 'tour around the world'. What were the main highlights for you during the past week, and what will you be focusing on this week?

A Kit Juckes

Well, let's see… Last week, the Reserve Bank of New Zealand (RBNZ) and the Bank of Korea (BOK) cut interest rates. The Chinese released data on industrial production and retail sales, which – to quote a colleague of mine – were "better, but bad", and their capital spending numbers were weak as well. The Greek debt crisis was not resolved, yet again, and time is (still) running out for them. Oil prices meandered to the top end of their range and then back down a bit. More importantly, May retail sales report in the United State showed signs of life and prompted upward revisions to second quarter growth forecasts…

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A Neil MacKinnon

As for the main market themes this week, it has to be Greece, the Fed's policy intentions, and the sell-off in global government bond markets – or what has been described as the unwinding of the global deflation trade. Just consider the magnitude of the changes in government bond yields over the last two months: the low in the 10-year German bund yield, the benchmark for Eurozone bond markets, was 0.075% on 20 April. Last week, it moved above 1.00%. Over the same time period, the US 10-year Treasury yield moved from 1.89% to 2.49%. These moves represent a sea-change in investor thinking and perhaps a turning point in the bull market for bonds. Certainly the so-called 'global deflation trade' looks dead and buried.

"These moves represent a sea-change in investor thinking..."

2 The Fed

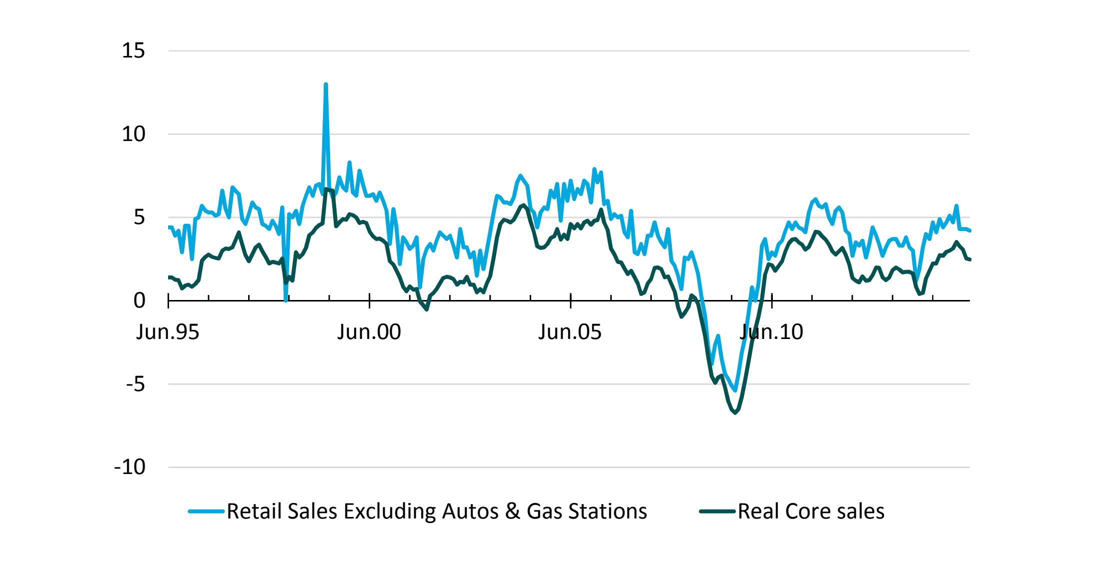
Q Andrew Rozanov

OK, let's start with the US and the Federal Reserve. Where do we currently stand?

A Kit Juckes

Well, after reasonably strong employment data the previous week, last week's retail sales figures were the key bit of news ahead of the FOMC meeting this coming Wednesday. Adjusted for inflation, sales are running at an underlying rate of about 2.5%, which is about the same rate as the underlying pace of growth of GDP.

US Retail Sales – Annual Percentage Change



Source: The ECU Group plc

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So the interest rate argument hasn't progressed much, but even so, we will pore over the Fed's words and the Fed's forecast, dots and all, this week. And I expect all that poring to leave us relatively convinced that, barring shocks and subject to the data, the FOMC will finally deliver the first rate hike of this cycle in September. **Shorter-dated US rates are likely to increase, but longer-dated rates less so, so the curve is therefore likely to flatten**. How much emerging markets and equities will react is unclear, though it's a fair bet that there will be some pre-hike nerves in both markets over the summer.

A Neil MacKinnon

As Kit just said, the FOMC meet this Wednesday 17 June. The markets are expecting no move until September. However, we are seeing a rebound in US economic activity. Private investment is now back to its historical average of 17% of GDP. Private sector net worth is at an all-time high, though this is mostly attributable to the rising values in equity markets and real estate. Household debt growth is low relative to past recoveries, as the fall-out from the 2007 crisis still lingers. Retail sales were up 1.2% in the latest month, Michigan consumer sentiment has rebounded, and producer prices rose 0.5% in May. We know that the Fed is not trigger-happy and might regard the recent pick-up in bond yields as an implicit tightening of monetary policy in itself.

"... the FOMC's own median interest rate projection for the end of this year is 0.625%, which implies two rate increases of 25 basis points each by the end of 2015."

Regular readers will know that I would prefer the Fed to start normalising policy this week – in fact, one can make the case that they should have moved on this much sooner, which would have given them more room for manoeuvre. However, as it currently stands, the FOMC's own median interest rate projection (the "dot") for the end of this year is 0.625%, which implies two rate increases of 25 basis points each by the end of 2015. As I just mentioned – and as Mario Draghi recently warned – this is all happening against the backdrop of much higher bond market volatility. I think the main risk for the Fed going forward is that their preference for some gradual and hesitant move in raising rates might be derailed by a much stronger economy and/or a material pick-up in inflation.

This would have direct and immediate implications for the US stock market. Specifically, as I have argued in the past, it leaves US equities open to a stiff correction, especially as a number of indicators such as M&A activity, stock buy-backs, leverage, and margin debt are all flashing 'red'. I would just like to remind you that this is the second longest period outside of 1929 where we have not had an equity market correction of at least 10%... So **while the global deflation trade may be at an end, it may still be somewhat premature to argue that there must be a 'global reflation trade' immediately ahead** – a trade which would logically imply long positions in equity and short positions in fixed income…

3 Europe

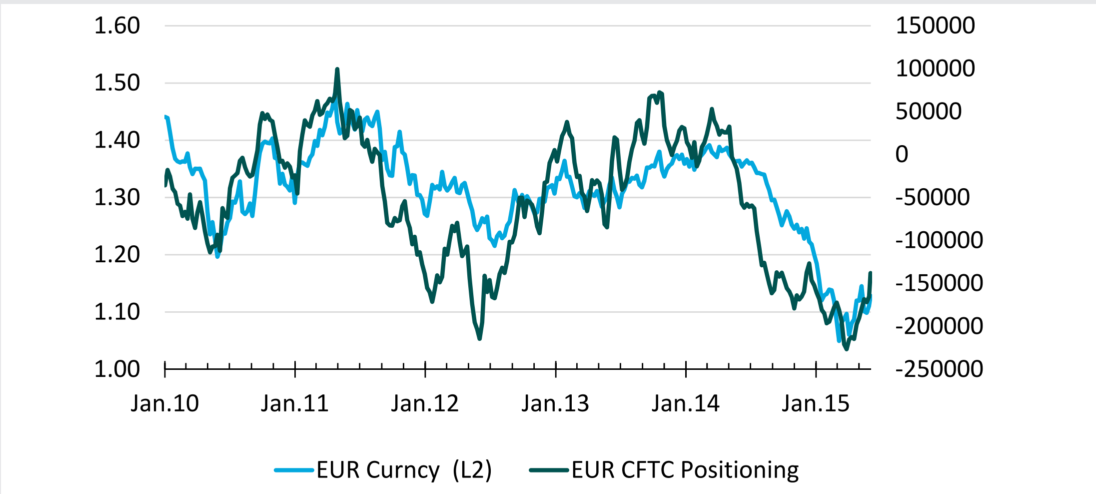
Q Andrew Rozanov

Let us now move on to Europe. The situation in Greece doesn't seem to be getting any better…

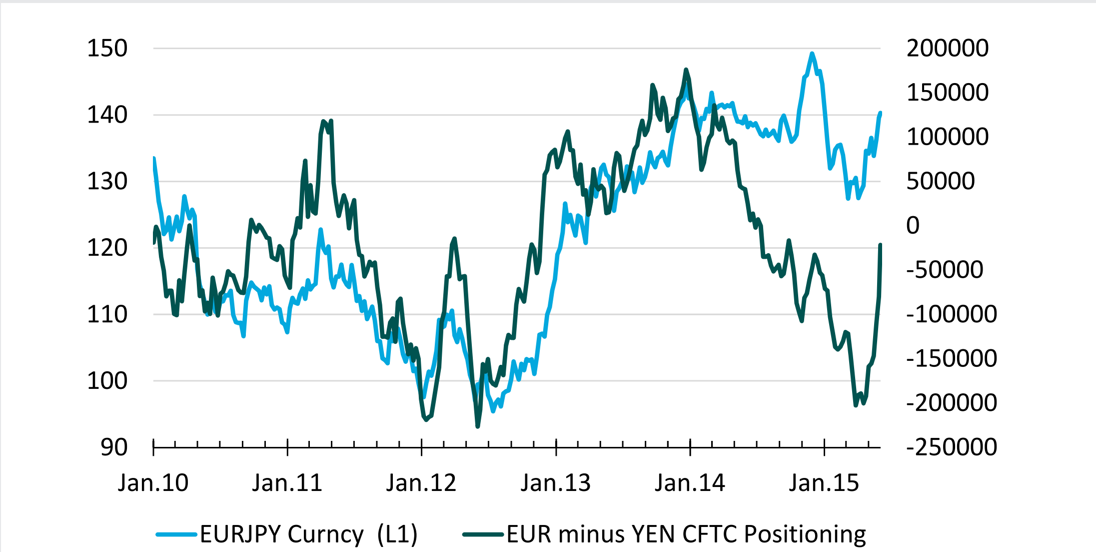
A Kit Juckes

Last week we were all waiting for a Greek debt deal to be finally agreed – and we still are! A week ago, we were in the 11th hour. Now, I suppose we're in the last minutes of the final hour, but still the gap between the sides is substantial. And yet, in my opinion, the odds probably still favour some kind of a deal. In the meantime, at least German Bund yields have stopped going up! That's a signal, of sorts, that the Euro's bounce is over. Incidentally, in this context, I think it may be interesting to look a bit more closely at EUR/JPY.

EUR and EUR CFTC Positioning



EUR JPY and EUR minus JPY CFTC Positioning



Source: The ECU Group plc, DataStream

The yen and the euro are both undervalued relative to long-term models of purchasing power parity (PPP) or fundamental economic equilibrium. That's not surprising, because what matters to markets these days is monetary policy divergence, rather than 'value'. But **JPY is a lot more undervalued than EUR, and the tide of news does not justify that**, in my view. Last week's CFTC FX positioning data show EUR shorts being cut back further. The latest bout of choppy range-trading has cleared a lot of the excess. I would say it's almost a 'green light' for EUR bears as the Greek news remains depressing. But it is the contrast with the JPY positioning that is particularly striking. While EUR shorts have been cut, JPY shorts continue to grow. There are enough JPY shorts now to deliver a sharp bounce on risk aversion: for example, a relatively hawkish message from the FOMC on Wednesday might become a double-whammy for EUR/JPY.

Elsewhere in Europe, we will see the release of labour market data for the UK this week, which will probably give us more substance than the recent warning from Moody's that a decision to leave the European Union could prompt a sovereign rating downgrade. I expect the UK CPI, wage and retail sales data to show a further pick-up in wage growth, a return to positive annual price changes and a solid sales gain. If so, there will be nothing here to hurt the pound in the short term. Still, with ratings agencies circling like buzzards and the UK's budget and current account deficits still eye-wateringly large, the pound could be vulnerable if the economy were to lose steam. So there is a bias to how markets will react to economic data, with weak numbers moving asset prices more. It's a good thing then that the odds favour OK data this week!

"...with ratings agencies circling like buzzards and the UK's budget and current account deficits still eye-wateringly large, the pound could be vulnerable if the economy were to lose steam."

A Neil MacKinnon

I take a slightly less sanguine view of Greece: I must say that I'm quite worried at this point. Just when you thought it could not get any worse, the markets were roiled by the news that the IMF had withdrawn its negotiating team. Trading off Greek headlines at the moment is a precarious business for sure. Market veterans, however, would surely not be surprised by the latest turn of events. Let's look at the facts. The Greek government is running out of cash. The Greek economy is still in recession, with the unemployment rate at double-digit levels. Even though the fiscal adjustment and the reduction in relative unit labour costs have been the most severe of any EU economy, government debt is still at 180% of GDP. It is generally recognised that Greece cannot repay its debts. The EU and the IMF now own 90% of that debt. Private bond-holders suffered an 80% haircut in the 2012 debt restructuring, but currently the EU and the IMF do not want to accept any haircut. German taxpayers will ultimately foot most of the bill, which makes it an extremely difficult call for Angela Merkel.

Forcing Greece to accept more austerity will depress demand further and will lead to a political deadlock in the country, perhaps forcing fresh elections which Syriza, I think, would inevitably win. **However the current situation plays out, a debt default looks inevitable, even allowing for the machinery of the IMF to afford a period of 'grace'**. Capital controls similar to the Cyprus situation are on the agenda. Ultimately, a 'Grexit' beckons, which might be the best option as Greece would then have full control over its own fate – in other words, it would be entirely up to them if they wanted to make a complete mess of it – and it would also have full control over its own exchange rate and fiscal policy. A devaluation of the New Greek drachma is necessary, and although there would be short-term costs, it is the only way out of the EU debt prison, in my view.

4 Plan B

Q Andrew Rozanov

But if there is a complete breakdown in negotiations and Greece does default, how does this situation play out? Is there a Plan B?

A Neil MacKinnon

"The notion that the Greek government will see 'sense' and capitulate at the last minute now looks totally implausible..."

The EU and the IMF certainly need a Plan B quickly, it seems, as Plan A clearly has little chance of success. The notion that the Greek government will see 'sense' and capitulate at the last minute now looks totally implausible to me. Greek banks have lost nearly a quarter of their deposits since November 2014, and the drain continues. A debt default would necessitate imposition of capital controls and perhaps ultimately an exit from the monetary union. How will this play out? Well, **recently there have been discussions about the possibility of the Greek government going for an 'Icelandic-style' default and a full nationalisation of the Greek banking system**. This proposition is both intriguing and ironic, not least because the Icelandic model was lauded by the IMF at the time it was implemented under the supervision of Mr. Poul Thomsen, who is now in charge of the IMF's relations with Greece and its European partners.

5 Asia

Q Andrew Rozanov

Let us now 'pivot' to Asia and emerging markets more broadly. In our previous conversations, both of you mentioned China as another potential source of risk for the global economy. For example, there are still risks of a possible 'hard landing' and an asset bubble collapse. But even if the Chinese authorities manage to successfully navigate these dangers without triggering a domestic economic or financial crisis, there is still the non-negligible impact of China's economic slowdown on commodity-based economies and emerging markets more broadly…

A Kit Juckes

It is true, Chinese data are important because the economic slowdown there shows no real signs of stopping yet, and that feeds through into weaker demand for commodities and weaker exports for a range of emerging markets and resource-focused economies. For the latest thoughts from the World Bank on what it all means and how it will lead to weaker growth in developing economies, I recommend consulting their latest Global Economic Prospects report (available to download here).

The biggest effect is clearly on Asian economies, and last week's interest rate cuts in Korea, which had been expected, and in New Zealand, which markets had not expected, surely tell a tale. I would say that India is probably the one country in the region with bright growth prospects and with one of the region's favoured currencies, but by and large, we're going so see Asian currencies weaken relative to the dollar for a while longer. The softness of growth in

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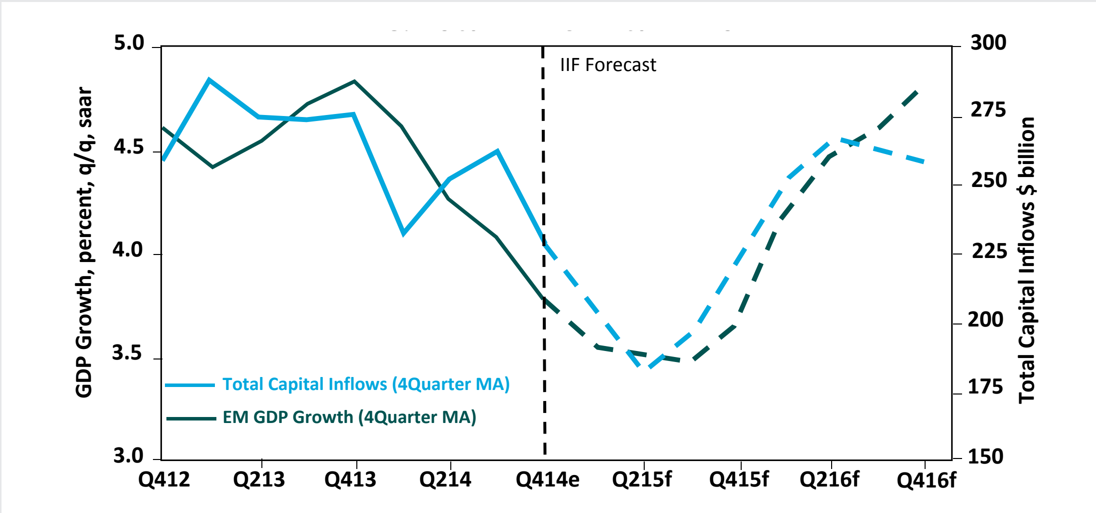
emerging market economies will also continue to act as an anchor for global inflation and, in due course, for wages. Deflation fears may have been exaggerated by the fall in oil prices, but 'lowflation' is far more likely than the kind of inflation some seem to expect.

A Neil MacKinnon

The following graph, courtesy of the Institute of International Finance (IIF), highlights the relationship between real GDP growth in emerging market (EM) economies and private sector capital flows into these countries. The IIF in their latest analysis project that EM private capital inflows will drop to US$ 981 billion this year, which would be the lowest level since the global financial crisis. The IIF do project a pick-up in EM capital inflows in 2016, but they rightly stress the risks related to the possibility of a more aggressive Fed tightening and continued stagnation in global growth.

Emerging Markets (EM) GDP Growth & Total EM Capital Inflow



Source: The ECU Group plc, DataStream

The latest monthly HSBC Emerging Markets Index fell to a 12-month low in May, with Brazil registering the fastest rate of decline since 2009. China and India are slowing. Russia is still in recession, with a pick-up expected in 2016 at the earliest. Growth in emerging markets has effectively ground to a halt, led by a near-stalling of global trade flows. Many EM economies will have to loosen monetary policy, with Russia cutting interest rates again this week. By the way, I am speaking at the St Petersburg International Economic Forum this week, alongside such luminaries as Prof Jacob Frenkel and Prof Kenneth Rogoff, where we will be discussing the outlook for the global economy. In our conversation next week, I will report back on these sessions.

Andrew Rozanov

Gentlemen, thank you for your input this week.

Biographies

Biography
Neil MacKinnon
Global Macro Strategy Adviser

Neil MacKinnon is a long-standing and independent member of ECU's Global Macro Team and Global Macro Strategist at VTB Capital, having been ECU's Chief Currency Strategist for six years.

Previous roles include Chief Currency Strategist at both Citibank and Merrill Lynch. From 1982 to 1986, Neil was an economist with HM Treasury, where he worked for the Chancellor of the Exchequer and other UK Treasury ministers.

Neil sits on the Advisory Council of Business for Britain.

Biography
Kit Juckes
FX & Fixed Income Adviser

Kit Juckes is a long-standing and independent member of ECU's Global Macro Team and Head of FX Strategy at Société Générale.

Kit has over 25 years' experience having commenced his career in 1985 with Money Market Services International (which became part of Standard & Poor's).

His former roles include Chief Economist at ECU, Global Head of Research at RBS Global Banking & Markets and Head of Bond and FX Strategy at NatWest Markets.

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