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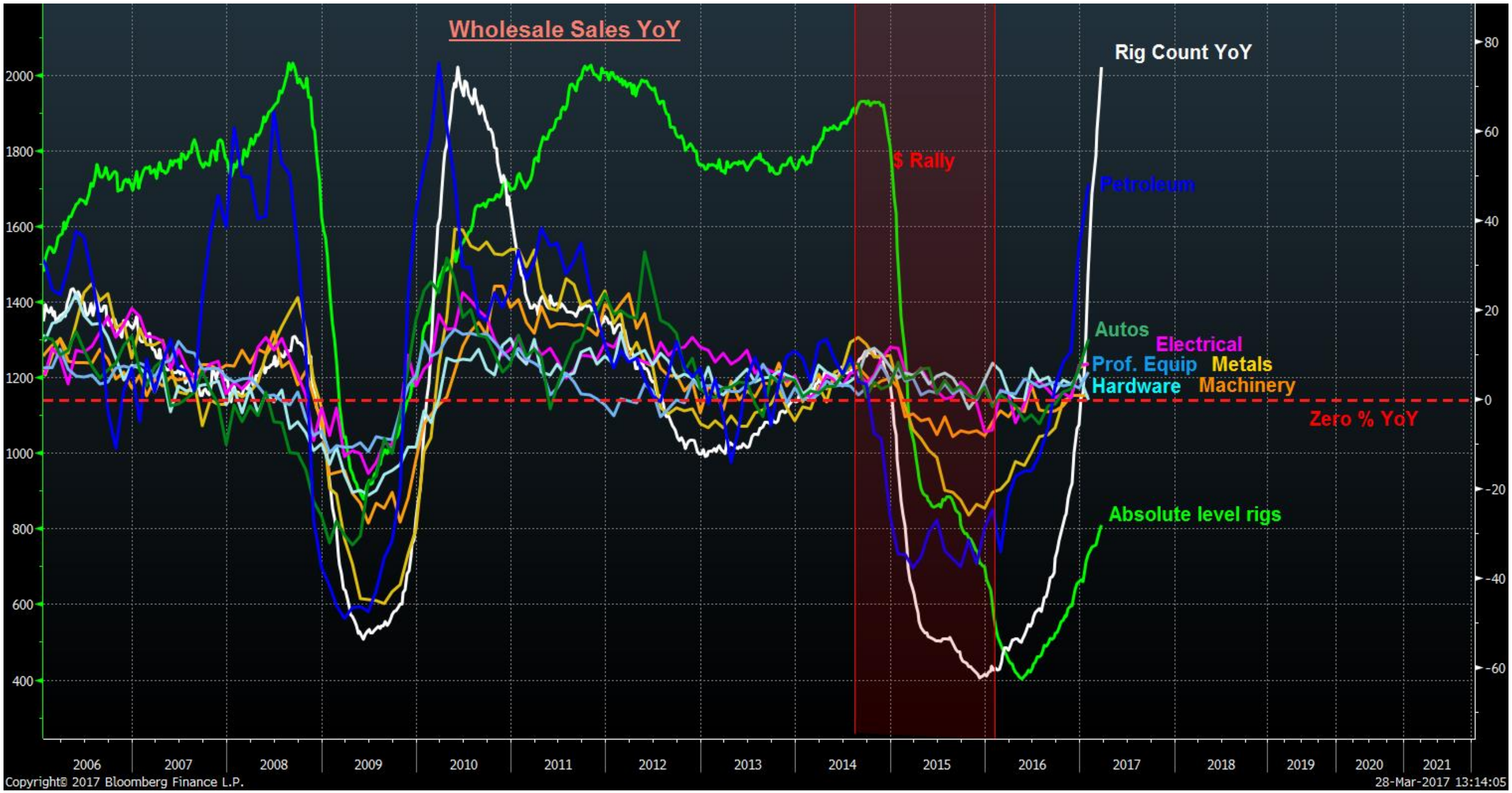
Macro Voices

March 2017

On Twitter: @JulianMI2

The $'s rally burst the US shale bubble and its pause unleashed a powerful base effect

Note how the absolute level of rigs has only recouped only 26% of its fall
But if we look at the speed or acceleration its up almost 80% YoY



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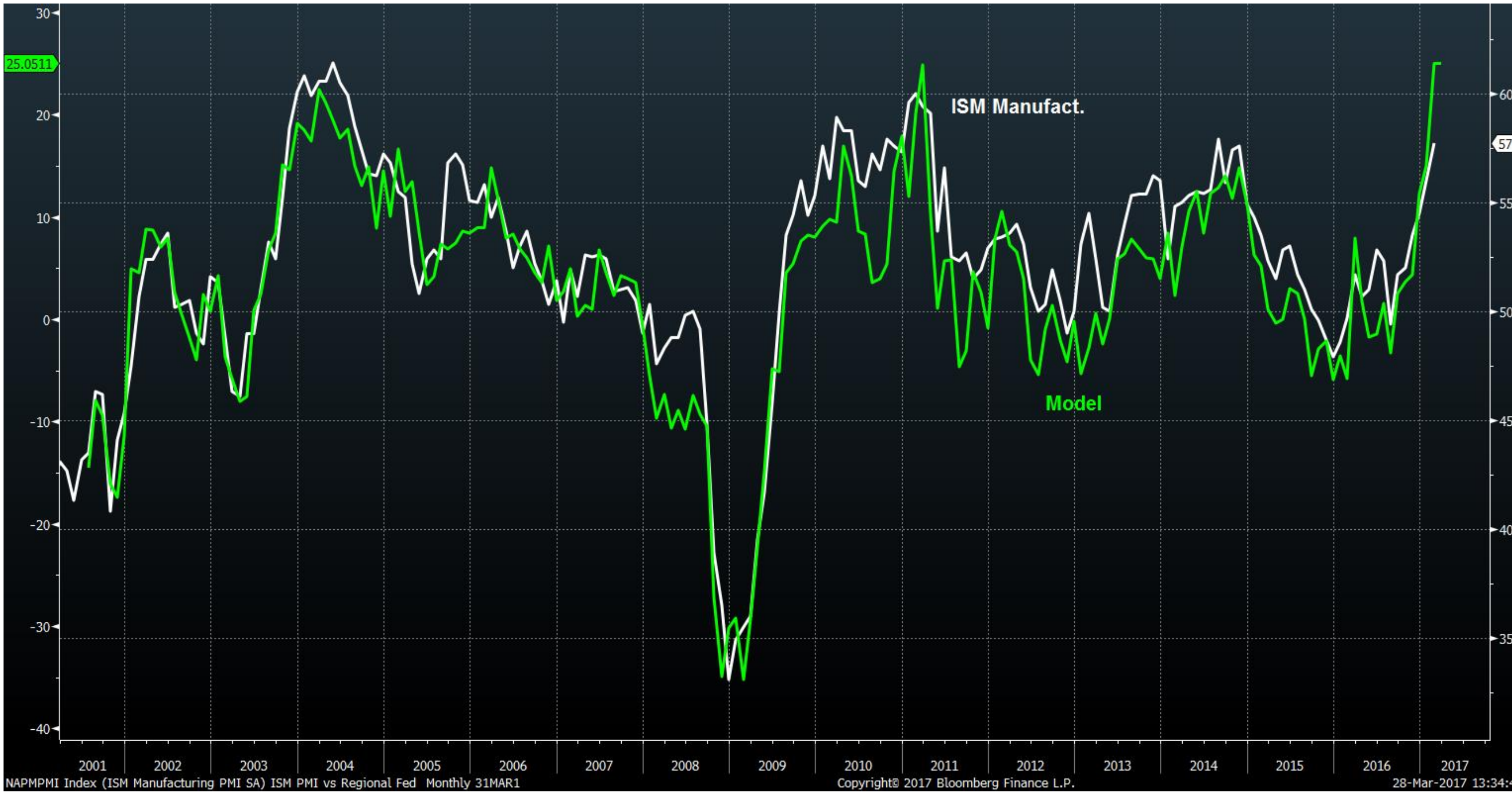
It's been very powerful but frankly it doesn't get any better!

Don't forget ISM is a measurement of the speed or acceleration

Our model caught the move perfectly but now suggests we are rapidly approaching a high

PS. Since 1985 ISM Manufacturing had been at or above 60 on 8 occasions



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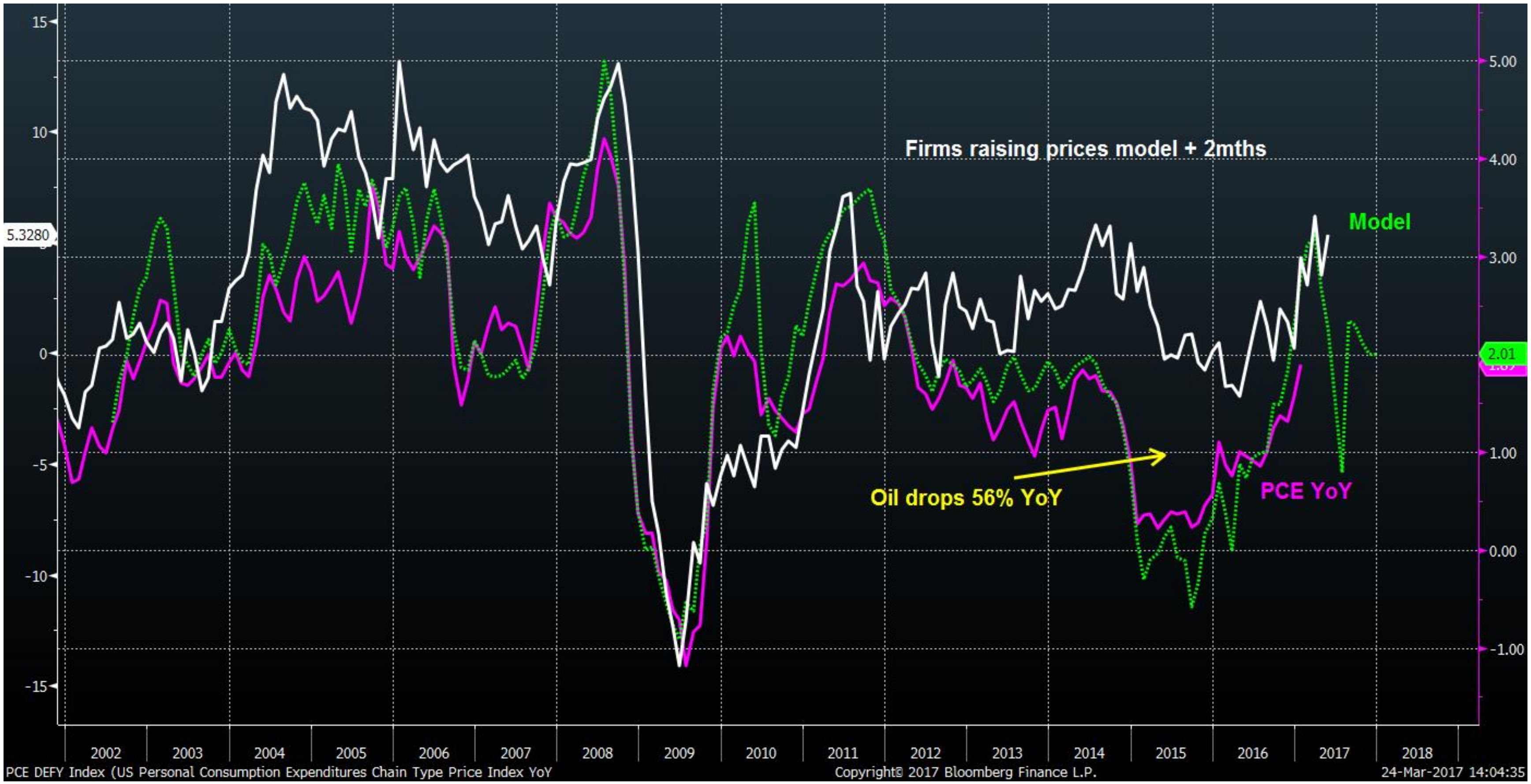
Adding to the downward pressure we expect <u>headline</u> inflation to peak and dip back in the next few months

Falling oil prices in 2014 led to a collapse in headline inflation and it's bounce has forced firms to hike prices
However the pressure should peak in the next two months



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In addition the tightening of financial conditions since last summer will start to impact the data

A stronger $ and higher rates since last summer will start to manifest itself in slower exports, overseas earnings, car sales and housing. For example mortgage activity suggests a disappointing spring sales season

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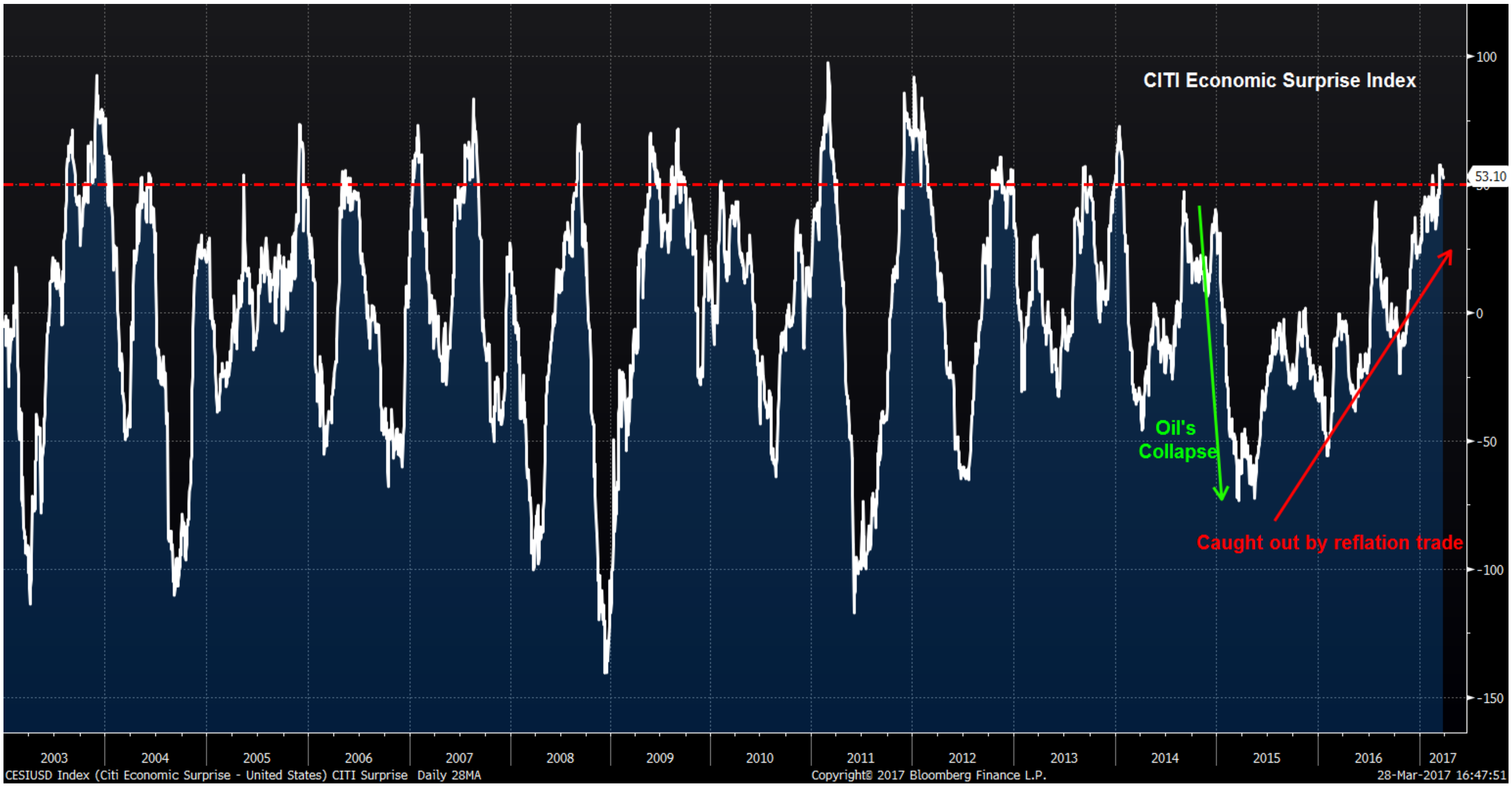
All of this is occurring with expectations at the highs

In 2014 economists were caught our by the economic fallout from oils collapse. Having spent the last two years playing catch-up as the perfect contrary indicators they are now bullish at the top!



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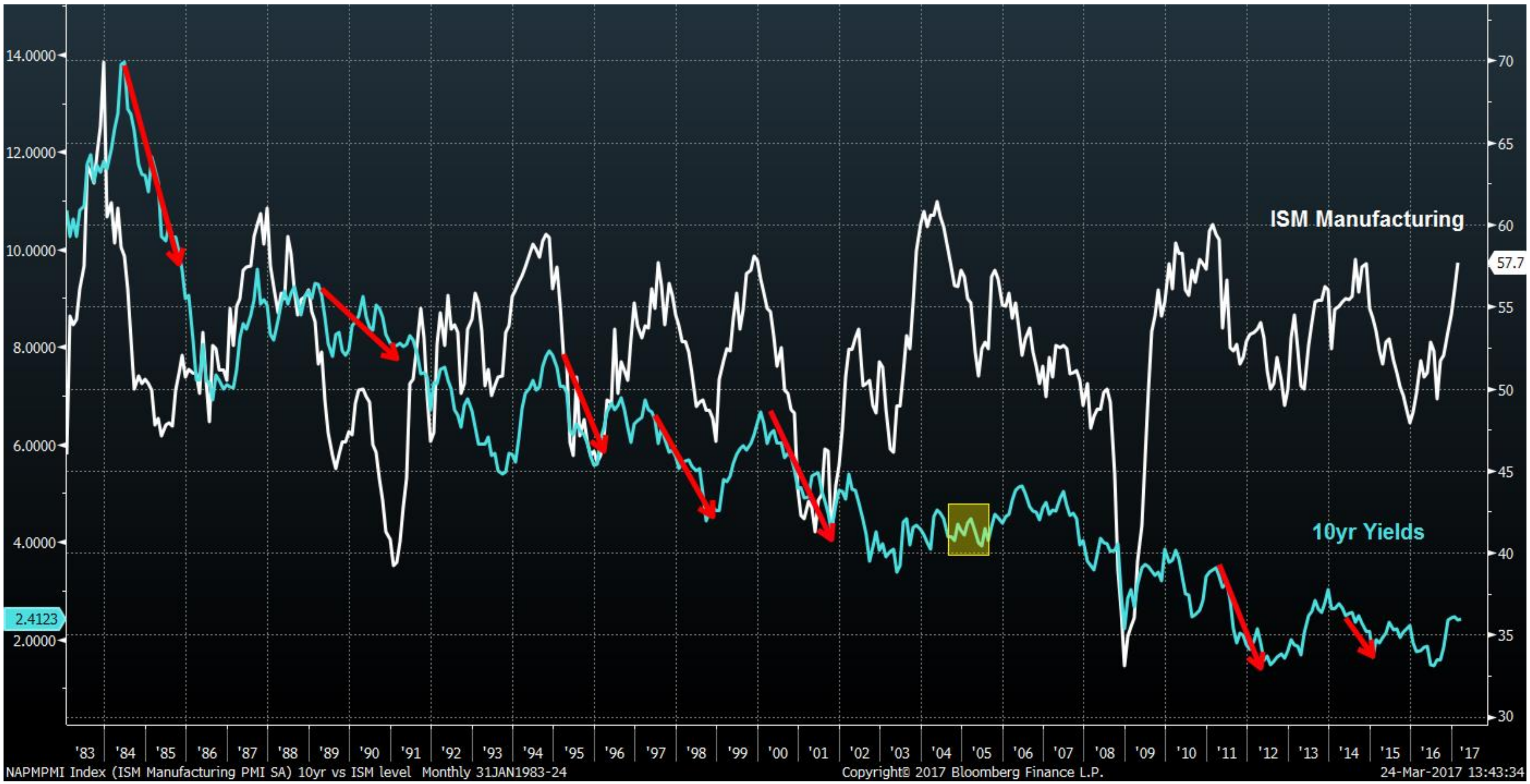
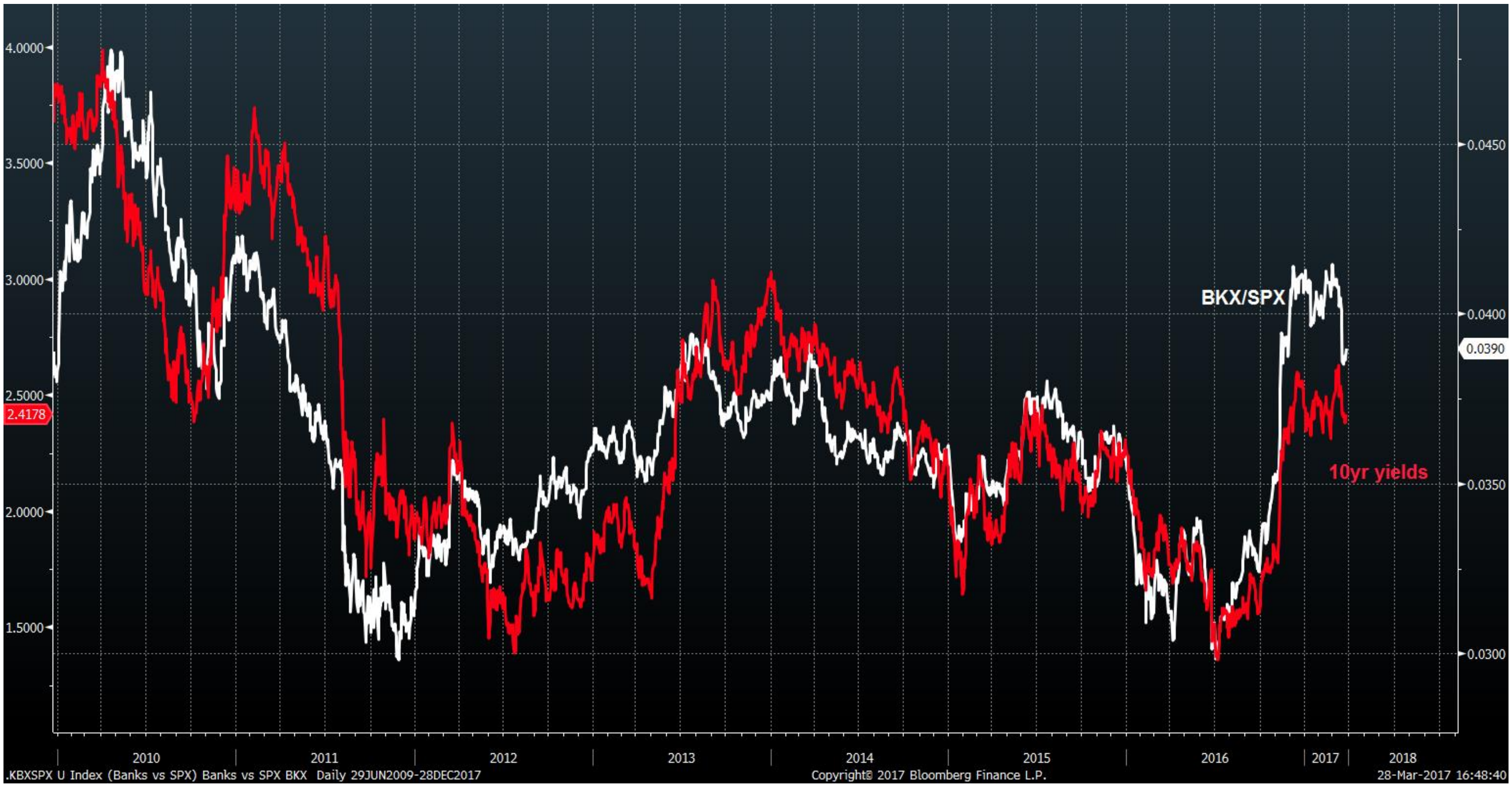
Therefore having been aggressively bearish Treasuries since last June we advised clients a couple of weeks ago "it is time to be out of US fixed income shorts for now"

Having hit 60 the subsequent dip in ISM is typically associated with lower yields



This is clearly a risk to reflationary trades

Banks have massively outperformed the broad market as Treasury yields have risen



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But note that we aren't structurally bullish on fixed income We are just playing a correction in the trend

One reason aren't structural bulls is that our model suggests unemployment keeps falling
Now it is below NAIRU this implies continued wage inflation. Even before Trump spends a penny on stimulus

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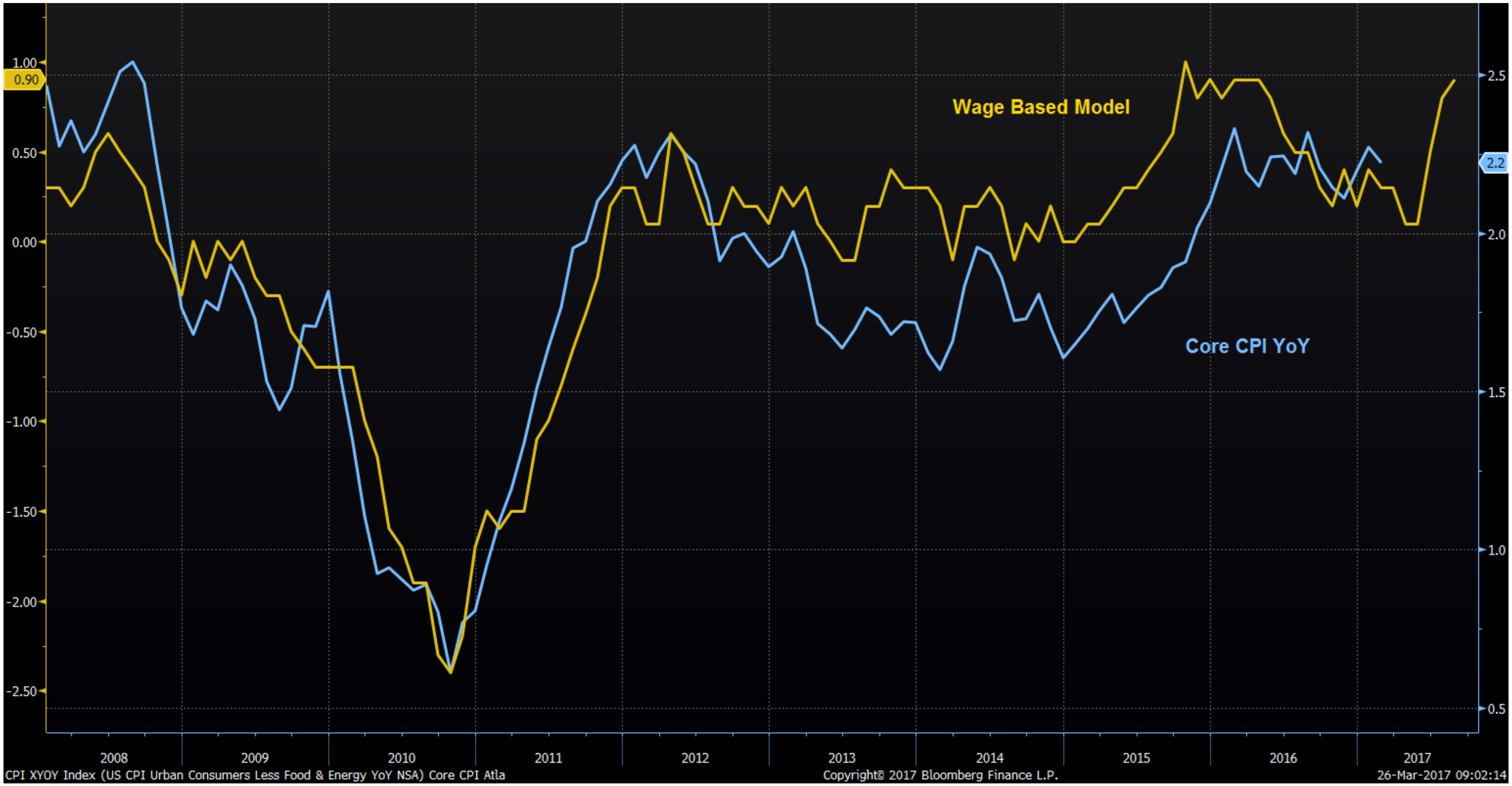
Higher wages will feed directly into core inflation

In the second half of the year rising core inflation will ensure the Fed keeps removing accommodation



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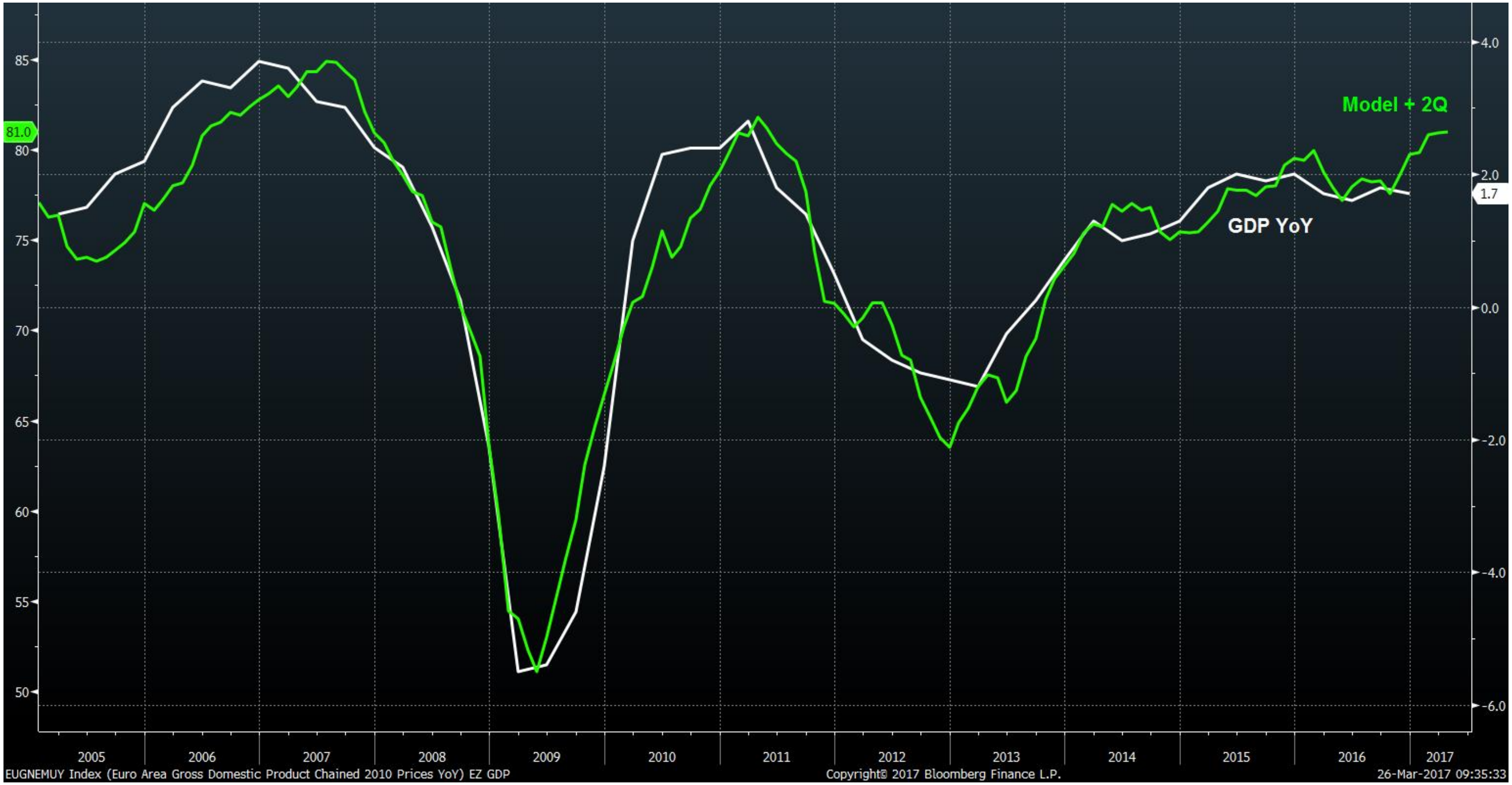
Rather we've shifting our focus to Europe

Where there's been little to no adjustment in bond prices

In Europe growth looks set to accelerate

There's been no tightening of financial condition on this side of the Atlantic!



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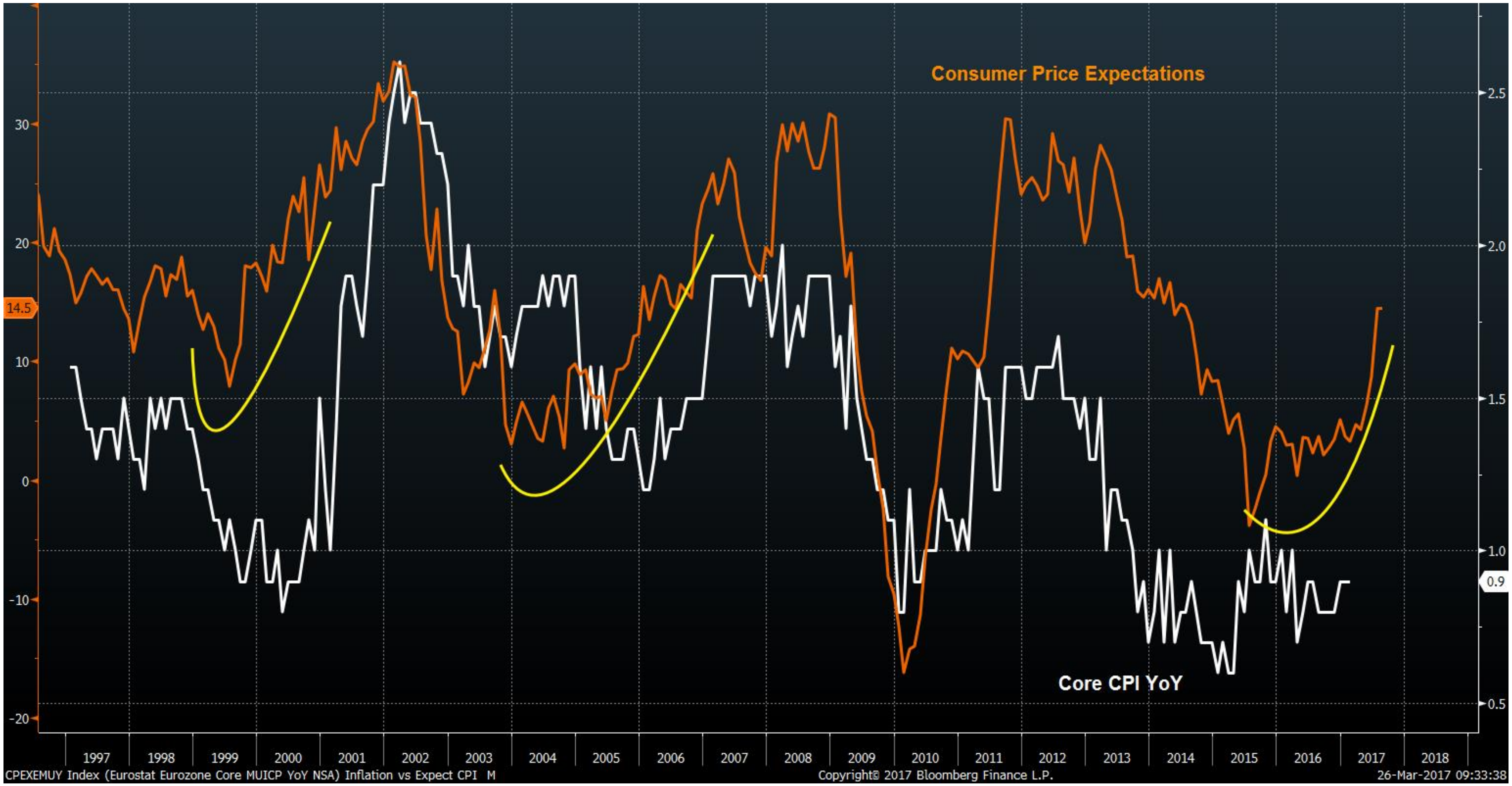
And after a typical lag core inflation looks set to move higher

Inflation expectations typically base 12-18mths ahead of core prices



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Draghi would have us believe that it's just a base effect of oil but we are seeing clear signs of secondary price pressure

"Stronger demand also allowed increasing numbers of firms to raise prices. ***Average prices charged for goods and services rose at the steepest rate since June 2011****"*

*"****Some evidence of rising wage growth and supply chain price pressures was also seen.*** *A lengthening of supplier lead times, indicating that demand was often outstripping supply, allowed suppliers to push up prices."*

Markit Eurozone Composite PMI

This has massive implications for relative pricing

Our industrial output models suggest the spread between Bunds and Treasuries should be closer to 150bps

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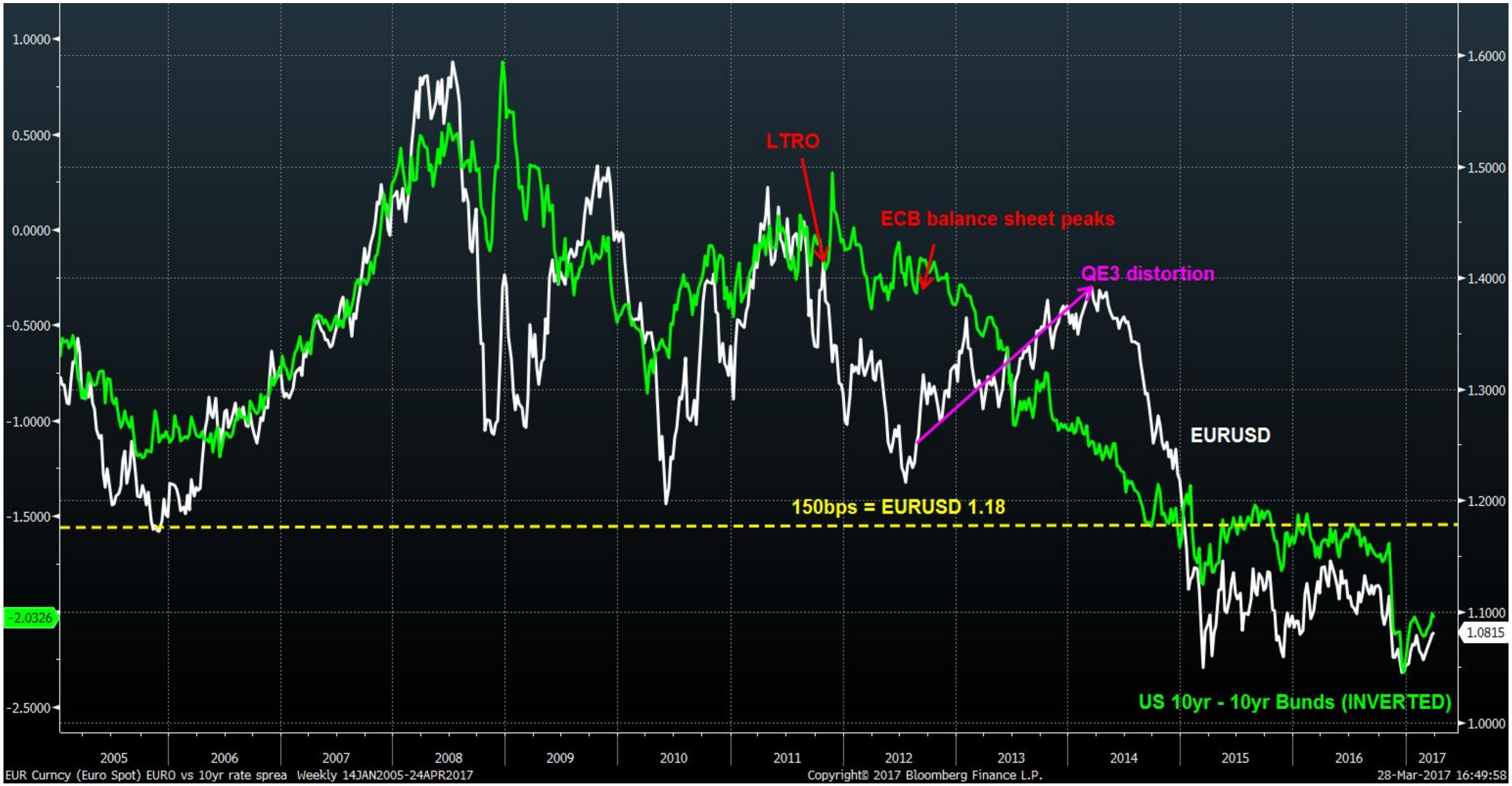
This in turn has implications for FX

As rate differentials narrow the Euro should strengthen



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