MACRO INTELLIGENCE 2 PARTNERS

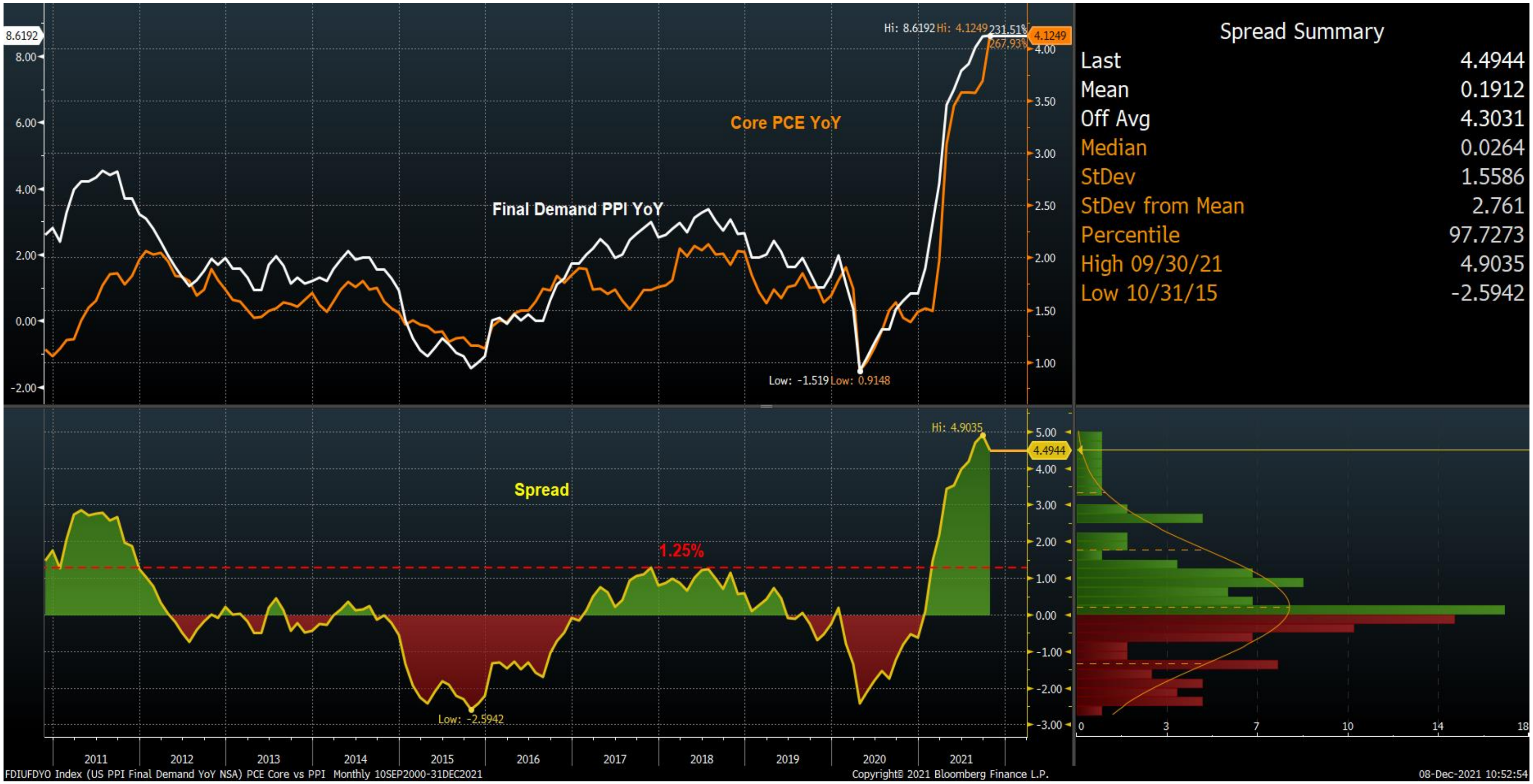
There's Behind the Curve and There's This

December 2021

The Fed is finally waking up to the inflation risks

In March J Powell said, "You'll see firms reluctant to raise prices" and he's been dead wrong.

If this spread narrows Core PCE could hit 7%!



Macro Intelligence 2 Partners

Furthermore even as headline rates wane we will have to contend with rising core price pressures

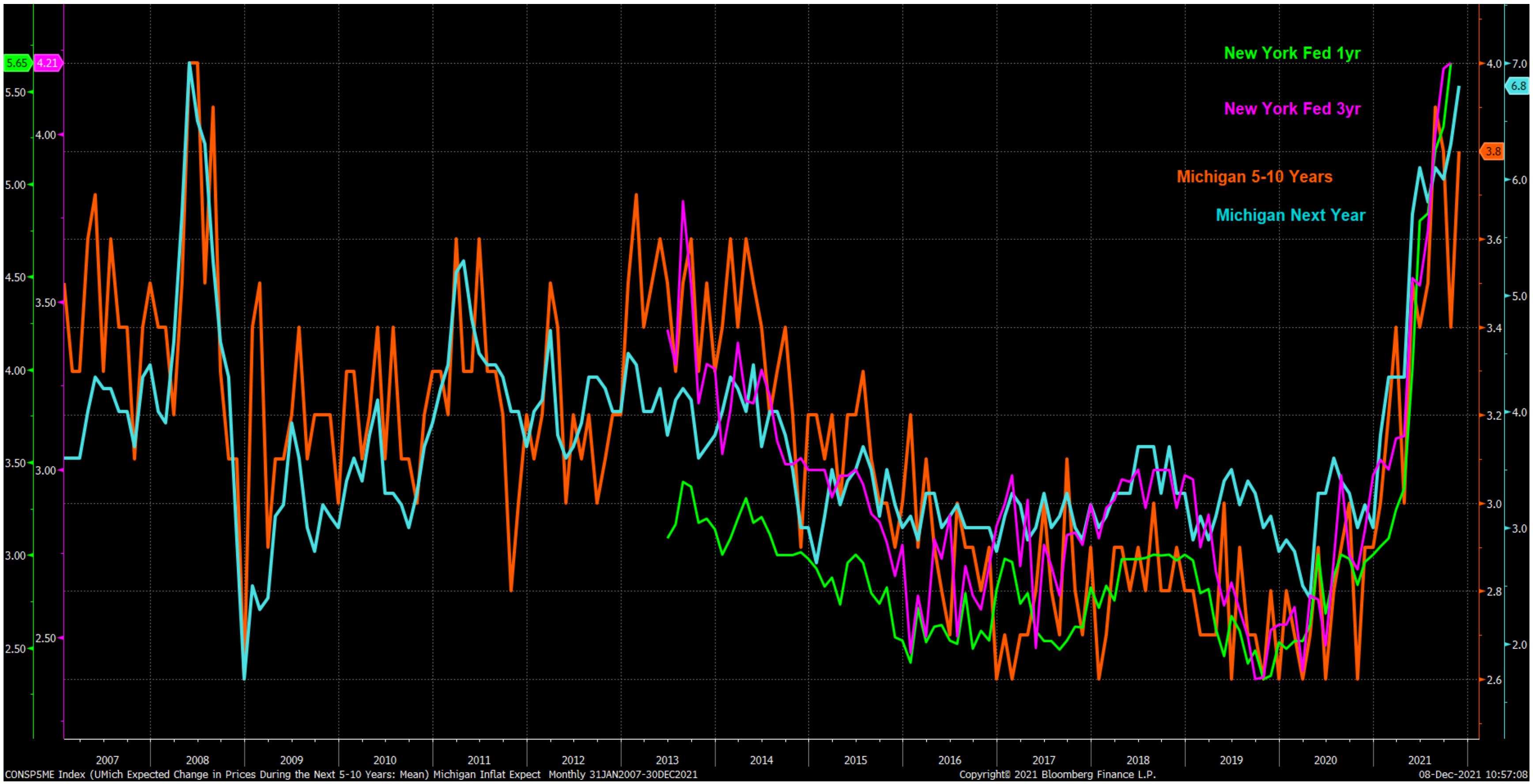
Our model, which we first showed you in March suggests OER could double to +4% by the end of 2022

PS. The Dallas Fed just predicted 6.9% by the end of 2023!

MACRO INTELLIGENCE 2 PARTNERS

And you don't want to mess with expectations

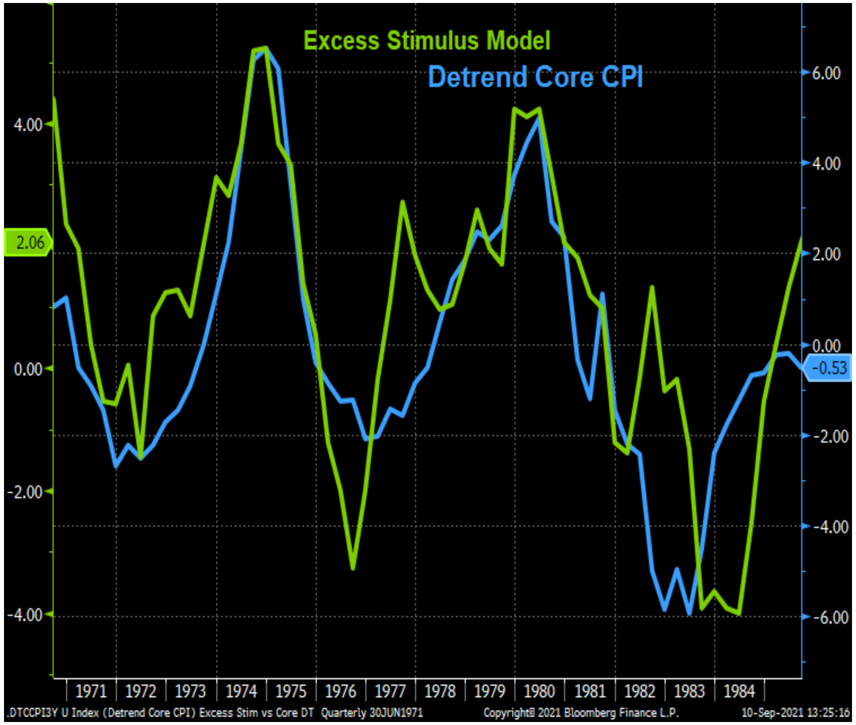
JP is on the record for saying that consumer inflation expectations will be transitory
But we are 18 months from the lows and he is playing with fire!
Their own work suggests that in the late 60's it only took 2 years for expectations to become unanchored

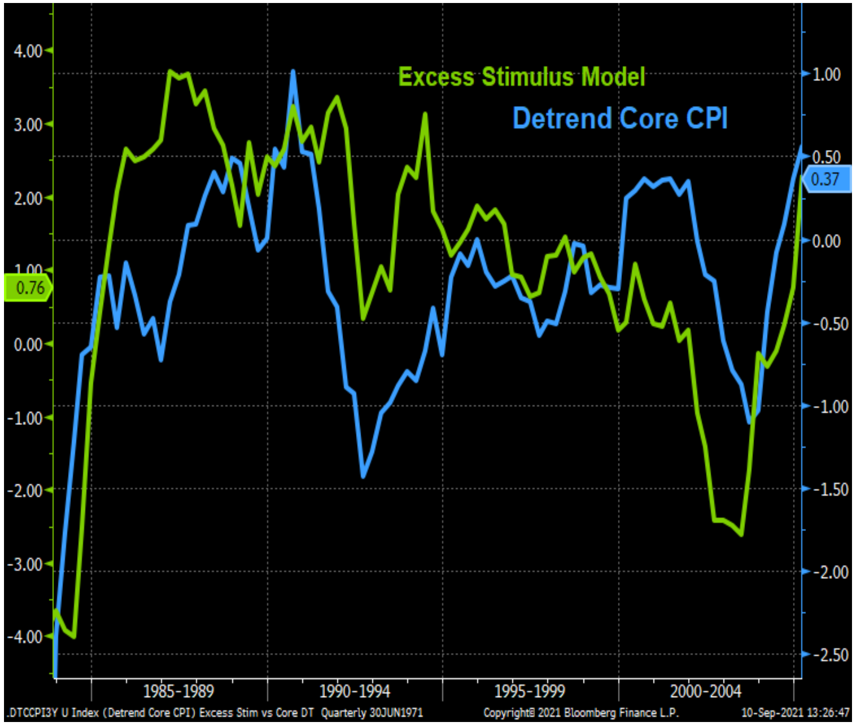


MACRO INTELLIGENCE 2 PARTNERS

The fundamental issue is that policy makers, especially in the US overdid the stimulus and forgot their history

Historically, while the magnitude of the relationship has changed over time
the combination of money supply growth and fiscal spending has typically led core inflation by a year





MACRO INTELLIGENCE 2 PARTNERS

Should we really assume it's different this time?

"Policymakers at the Fed and in the (White House) need to recognise that the risk of a Vietnam inflation scenario is now greater than the deflation risks on which they were originally focused. Whatever was the case a few months ago, it should now be clear that overheating -- not excess slack -- is the dominant economic risk." *Larry Summer May 2021*

PS this is an incremental model . Therefore by the start of 2023 core CPI could close to 10%

MACRO INTELLIGENCE 2 PARTNERS

Let’s not forget that aggregate demand has exploded

Personal consumption expenditure on goods is 34% higher that pre-Covid. No wonder we have supply constraints

In theory, we can rotate into services, which is below trend. But demand is already above prior highs

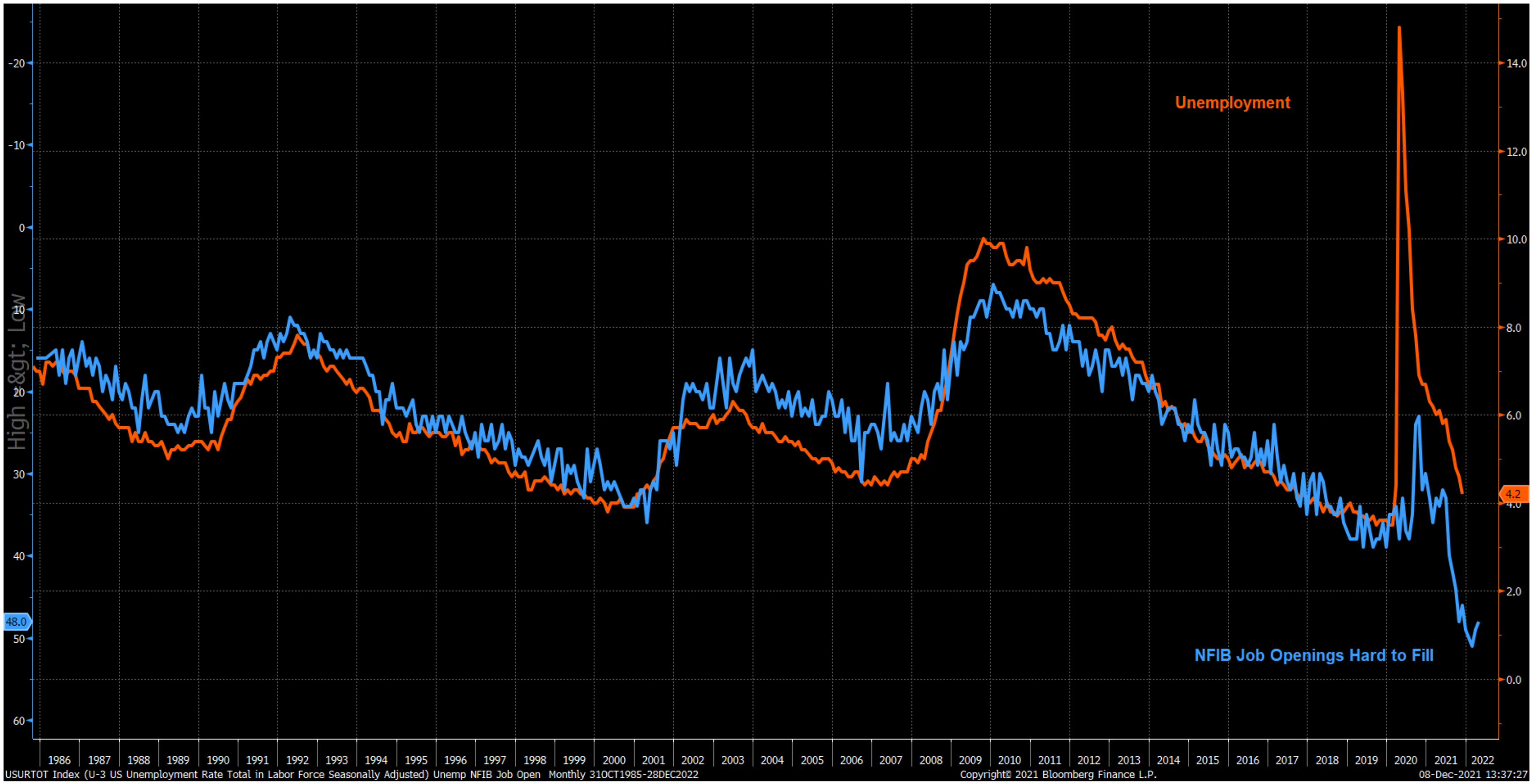
"Keep in mind that companies from the manufacturing sector are supplier-providers to the services sector. So, what you are seeing, is on one side impacts the other side". ISM Services

Macro Intelligence 2 Partners

While labour demand is at historical levels

Even if everyone comes back to work we are going to overheat!

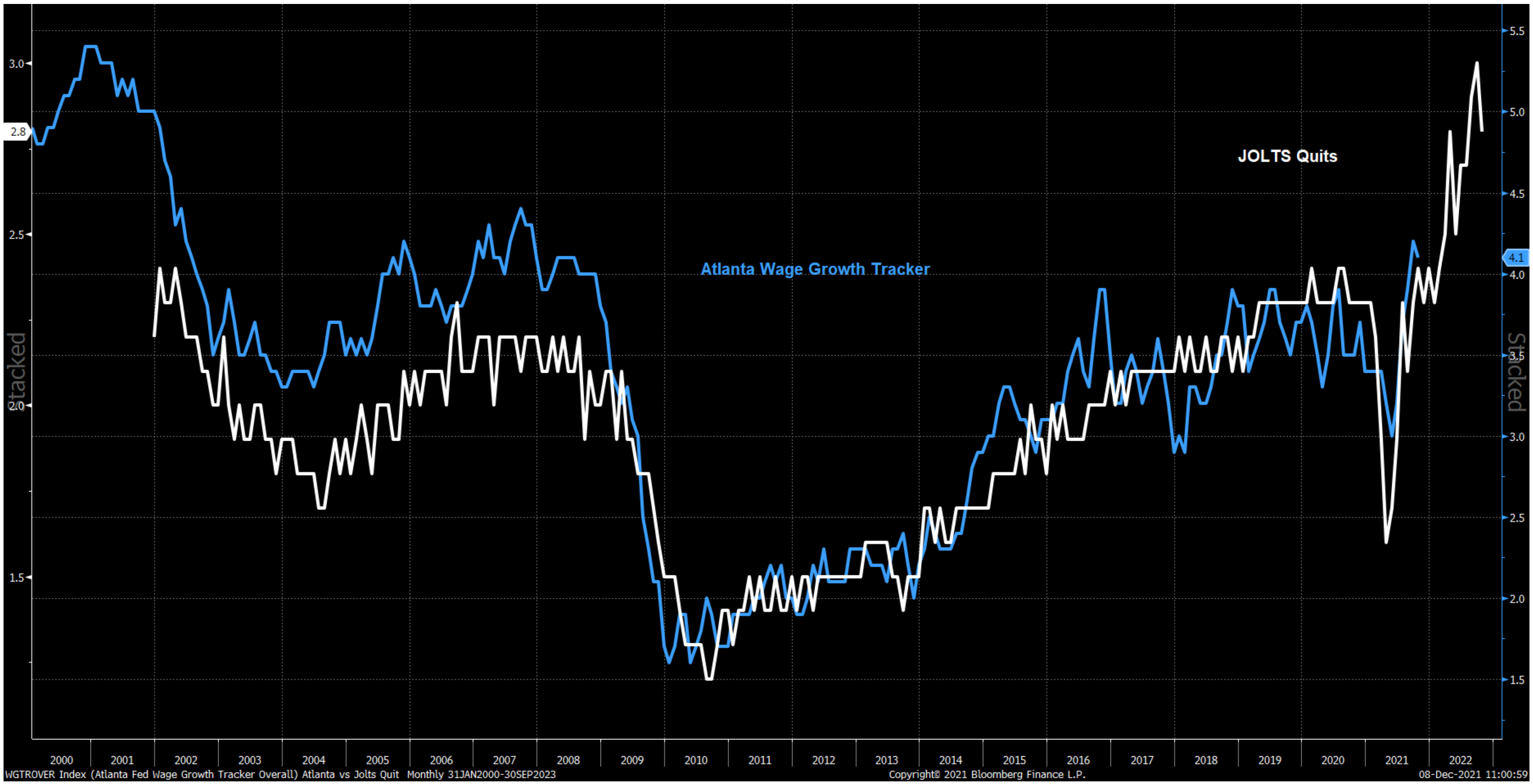
PS The talk is that the Fed see 3.8% as full employment and at this rate we will be there in February



Hence, we dismissive of JP’s no existent “wage spiral”

“People are chasing wages. 27% of my employment comments were related to attrition. You hire two people on a Monday only to see others leave on Friday to the factory down the street” It's not clear when this (wage) spiral stops“

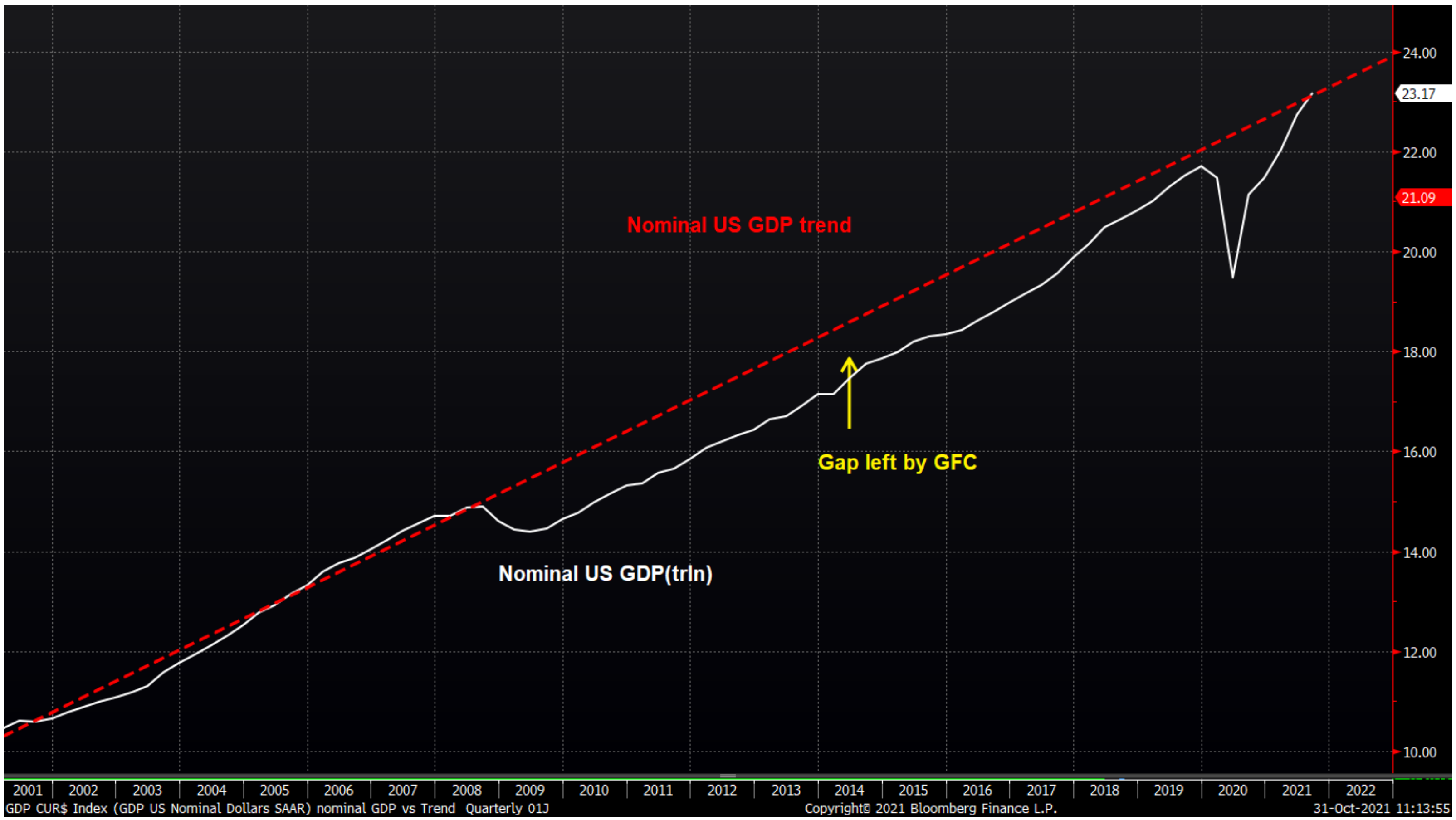
Tim Fiore ISM Manuf.



MACRO INTELLIGENCE 2 PARTNERS

And this is happening in an economy where the output gap has already closed!

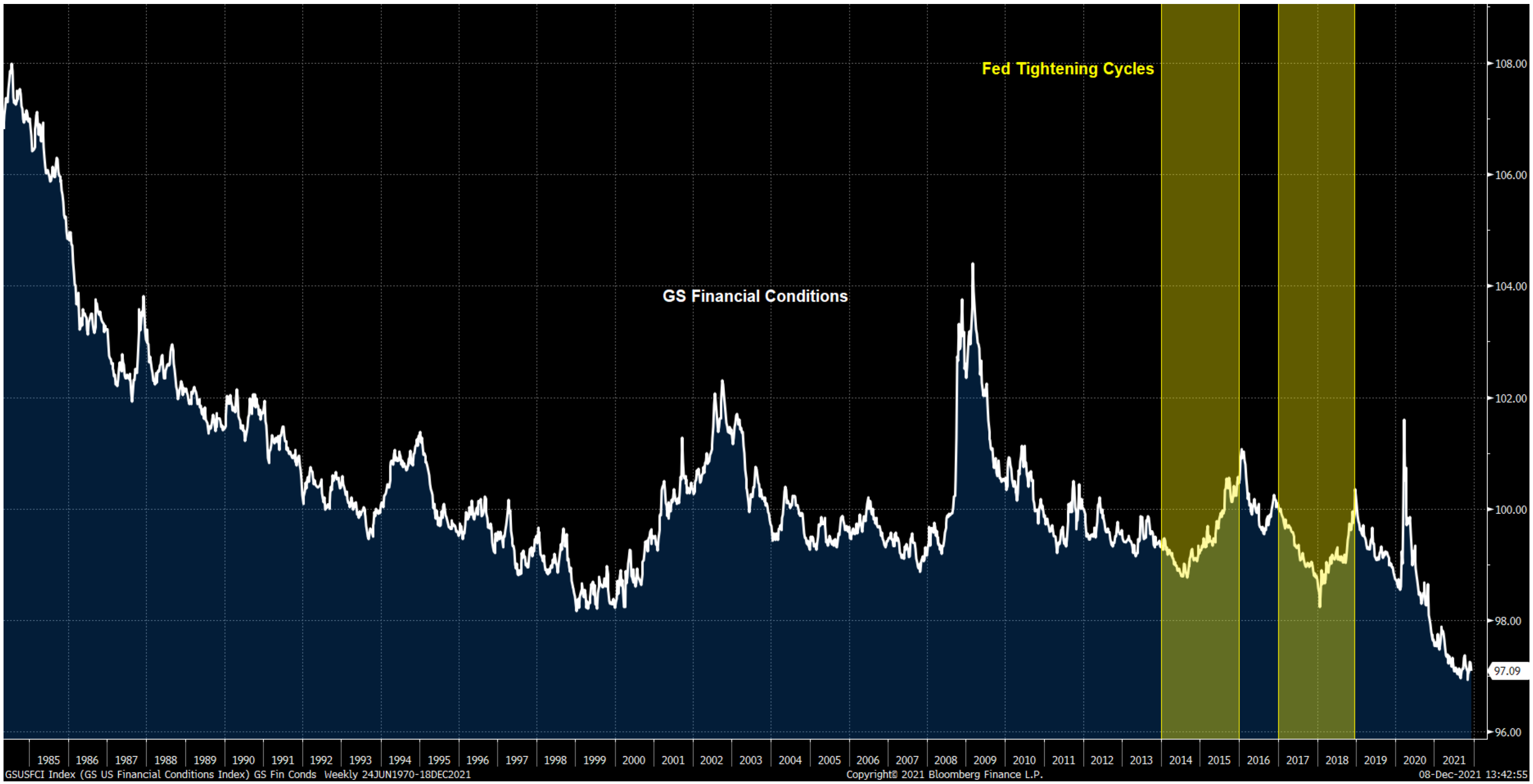
"On an annualized basis, (the PMI index) translates to a 6.1% GDP
That's almost like the inflated numbers we hear from China" Anthony Nieves ISM Services



MACRO INTELLIGENCE 2 PARTNERS

Ask yourself with this backdrop does the US really need the easiest financial conditions we've had in 38 years?

Despite recent moves in short term yields FC (stocks, 10yr bonds, credit spreads and dollar) have actually eased!!!!



Macro Intelligence 2 Partners

Don't take our word for it
Here's what Bill Dudley has said!

The theory suggests you can either have early and slow or late and fast. You can't have the best of both worlds!
Hence his concerns about a policy error!

Speed

"*Stage three (of the inflation process) will arrive when the economy reaches full employment, and inflation has reached 2% and is expected to keep climbing. At this point, the Fed will start increasing short-term interest rates. The tightening process will probably have to happen quite briskly — perhaps at a rate of about* <u>*2 percentage points a year*</u> *— given that there will be a long way to go from near zero to a level that would make monetary policy restrictive.*" 23rd February

Terminal Level

So how high will rates need to go? This depends on how easily higher rates will tighten financial conditions and cool off the economy. So far, there's little sign they'll have much effect. All this suggests, the Fed will have to raise short-term rates by considerably more than what's currently anticipated. The last time the central bank faced unresponsive markets, between 2004 and 2006 it had to increase rates to 5.25% from 1%. That episode may be a better template than the last business cycle. 3rd Nov

MACRO INTELLIGENCE 2 PARTNERS

If Bill is right and we think he is the terminal rate need to be a lot higher Do we need another Taper Tantrum?

Despite a slight rise nominal yields real yields remain at historic lows
Hence, why other assets are able to ignore the move

MACRO INTELLIGENCE 2 PARTNERS

Higher rates are a risk to stocks but liquidity is the biggest threat S&P @ 4850 by April but then what?

But when the balance sheet stops expanding, it's time to be very careful
P.S. Note how the S&P has just bounced to the level suggested by the balance sheet

MACRO INTELLIGENCE 2 PARTNERS

We are also watching credit very closely

If Financial Conditions are far too easy then HYG is very vulnerable

MACRO INTELLIGENCE 2 PARTNERS

This creates a real dilemma for the Fed and indeed all CBs

They should be tightening to tackle an overheating economy

And according to Dudley the longer they delay the move
the faster they have to go once they start and the greater the risks

Yet they have committed to support government

The Fed has been cajoled to stand behind the Biden Administration's employment objective and fiscal spending

And if they tighten too-far they will undermine assets and the economy

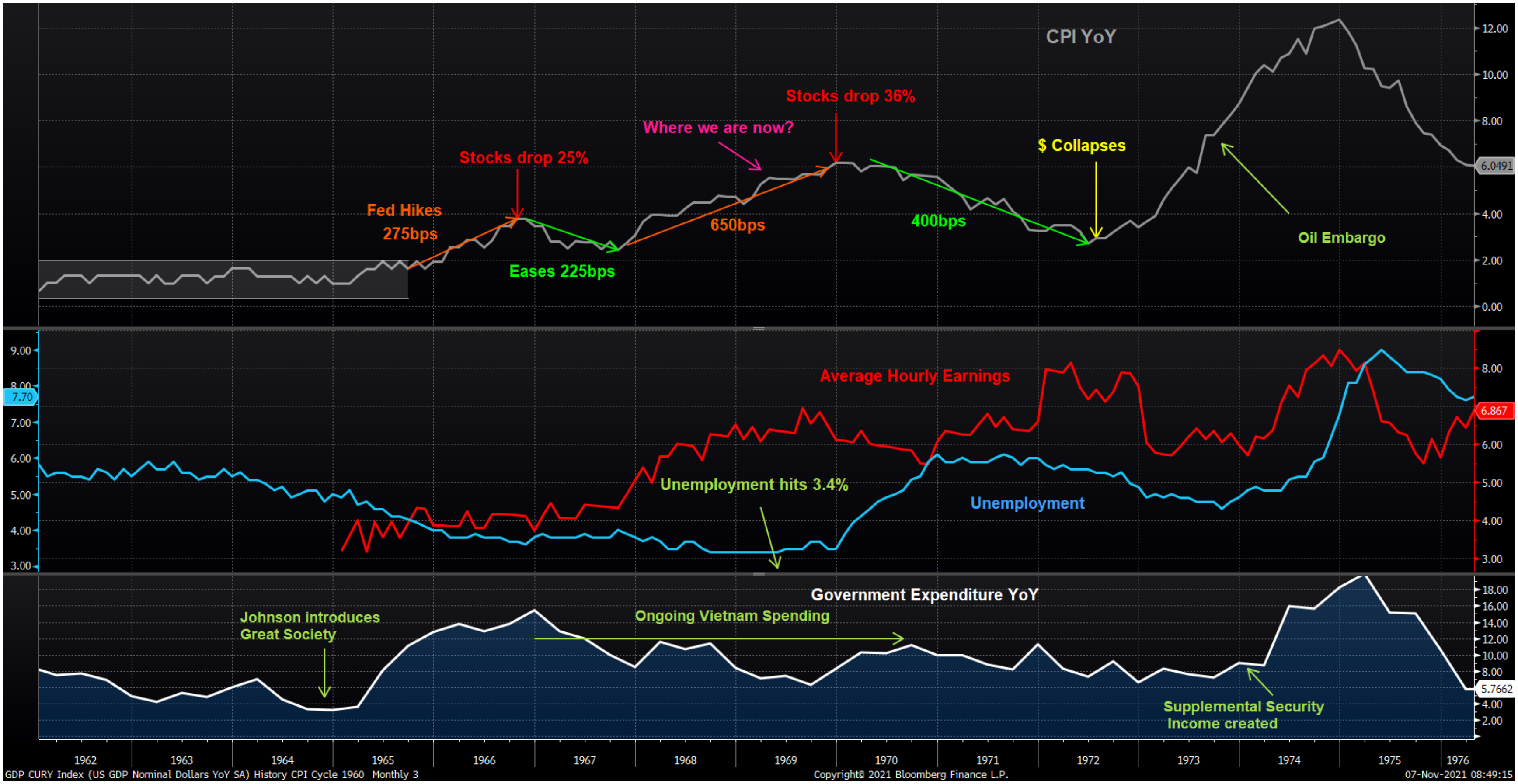
The financialisation of the economy means they are trying to thread a needle

They are snookered
Hence policy will be reactive
setting us up for an accelerative oscillation

Don’t forget in the 1960’s they faced the same problem!

In the late 1960’s, after a halcyon period of stable inflation excess government spending from Johnson’s Great Society and the Vietnam War triggered an acceleration in inflation

The result was a series reactive poorly timed policy responses and an accelerative oscillation



As in the 1960s
the Impossible Trinity
means there's only one end game

The Fed must pick. They can only control 2 out of 3 variables

- Stocks aka the real economy
- Bonds aka accommodate government
- FX

Ultimately the choice is clear

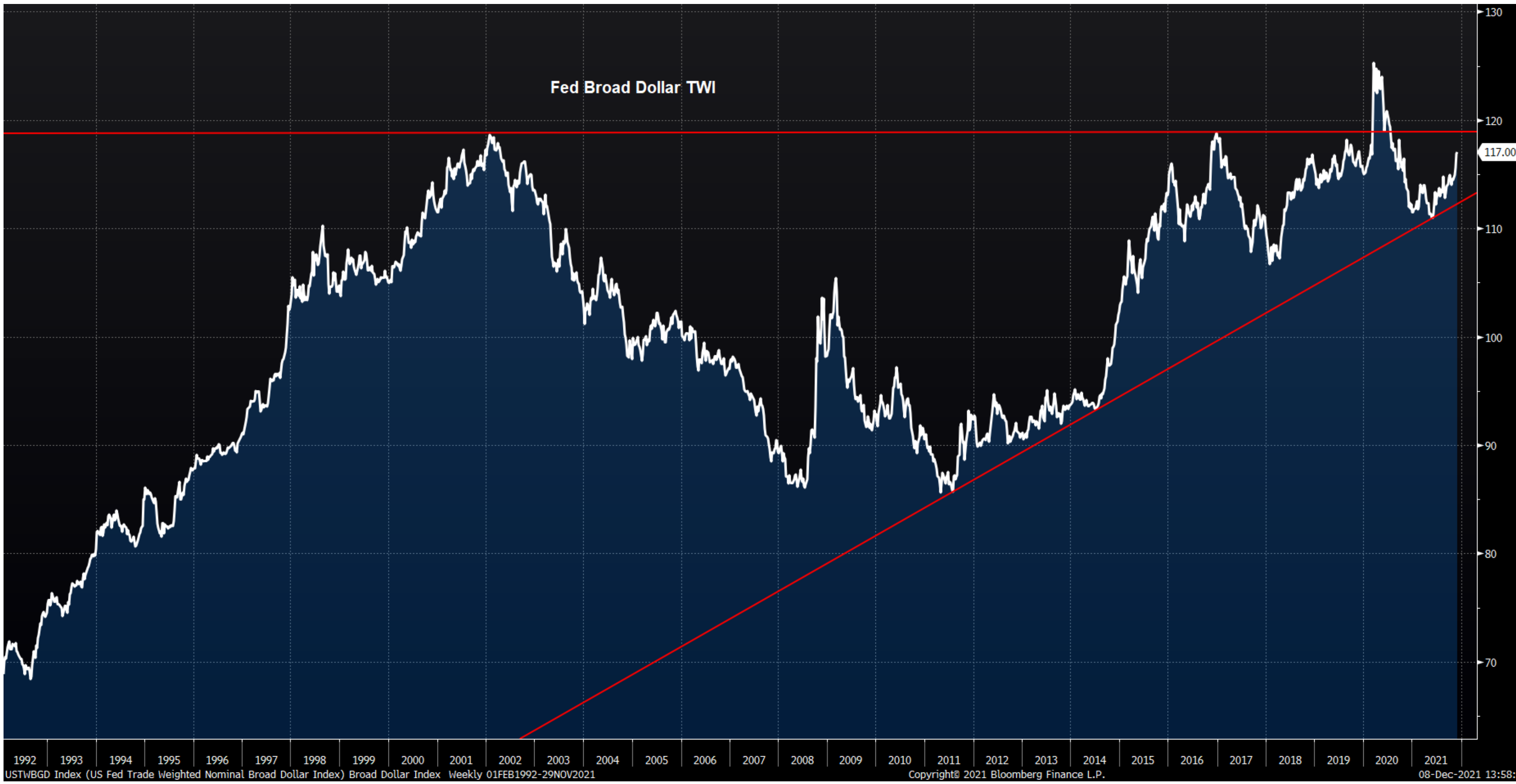
But the process won't be linear, but eventually pain inflicted
by the Fed or bond markets will bring us to the inevitable

They must support stocks, subsidise bonds and sacrifice the dollar

MACRO INTELLIGENCE 2 PARTNERS

For now the time isn't right

Given that most central banks remain behind the curve FX is difficult game
But these dynamics could change rapidly if we break any of these key levels!



MACRO INTELLIGENCE 2 PARTNERS

MACRO INTELLIGENCE 2 PARTNERS