Red string of fate ties the US to China

Is the Fed truly dovish?

- **I recommended to add to long 10yr UST (opened at 2.60%) at 2.45%.**
- **US 5s30s UST flattener (25bps in the money) – The Fed's so called "dovishness" relies on falling behind markets expectations but the Fed is not dovish per se. The curve should continue to bull flatten.**
- **Stay short US equities (Russell / SPX 3.8/2.3% in the money) but tighten stops in order to protect profits.**
- **I still believe the USD can weaken further but have recommended to take profit in long EUR and JPY (2%/2% profit) due to the high correlation with other positions. I will look for opportunities to re-enter.**

1. The Fed's March meeting has confirmed that JDI's understanding of the Fed is valid…

The question is: will reactive dovishness be enough to continue supporting risk in 2017?

I am re-using a paragraph from the last report here because the Fed's reaction function is at the heart of the market's dynamic. I will refer to it often in this piece, hence the reason I feel it necessary to reiterate my core belief.

An economy's growth potential is nothing else than labour input + productivity gains. With the cyclical part of the productivity cycle relying on a necessary boost in aggregate final demand to trigger investment decisions, it is crucial to see

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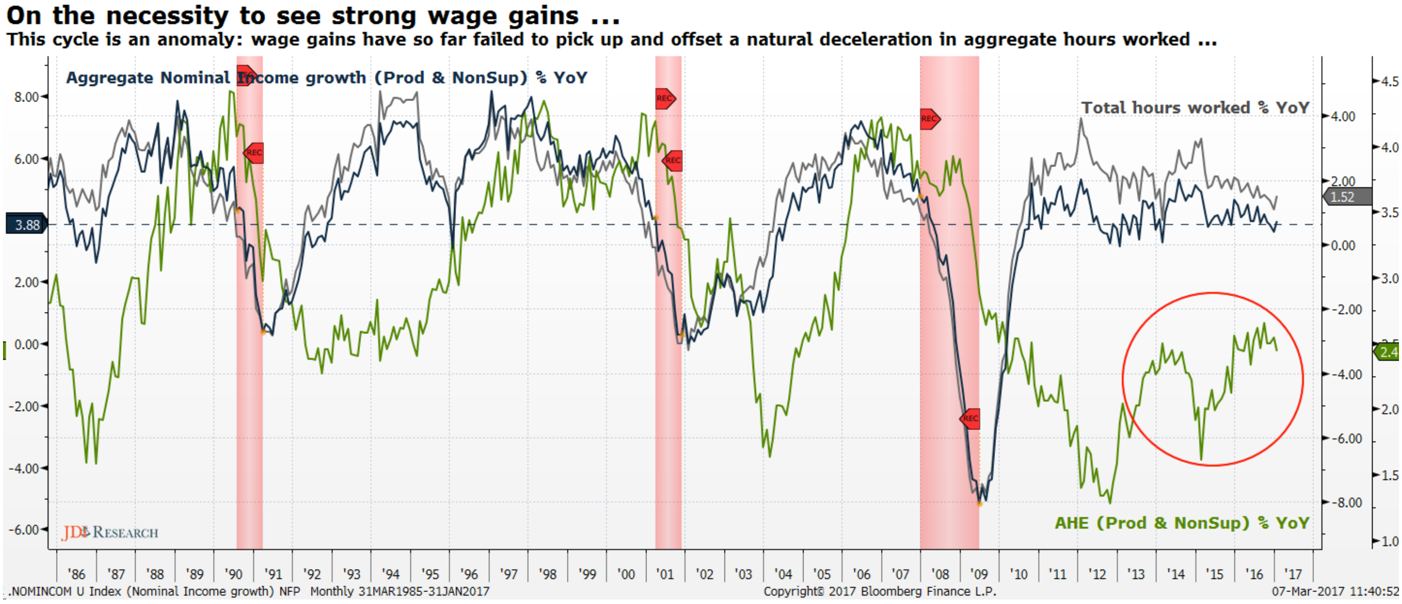
aggregate nominal growth stay supported for aggregate domestic demand to remain robust and for the business cycle to be prolonged.

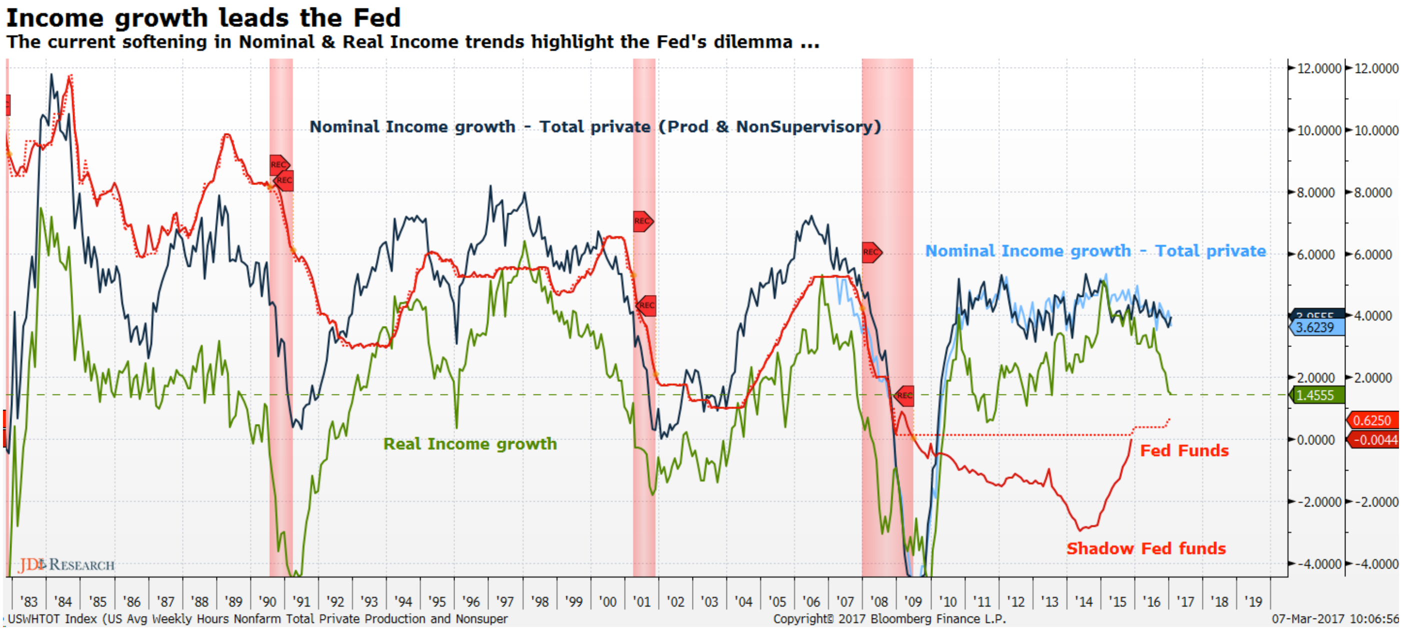
Currently, confidence is at sky-high levels across the economic spectrum and CEOs are on the starting blocks desperate to find reasons to invest. Unfortunately, even if a business cycle does not die of old age, old age does not promote good health either and this cycle looks particularly fragile due to **worrying aggregate income and therefore demand trends.**

Every previous cycle has seen wage gains pick up strongly as the labour slack disappears; this allowed real wage growth to offset the deceleration in employment growth in boosting real income and supporting aggregate demand. A 1% increase in real wage growth is equivalent to employment gains of 120k per month for a year. This is of course the reason why **aggregate earnings** (rather than payroll's headline) **is the only relevant data to keep on the radar this late in the cycle.**

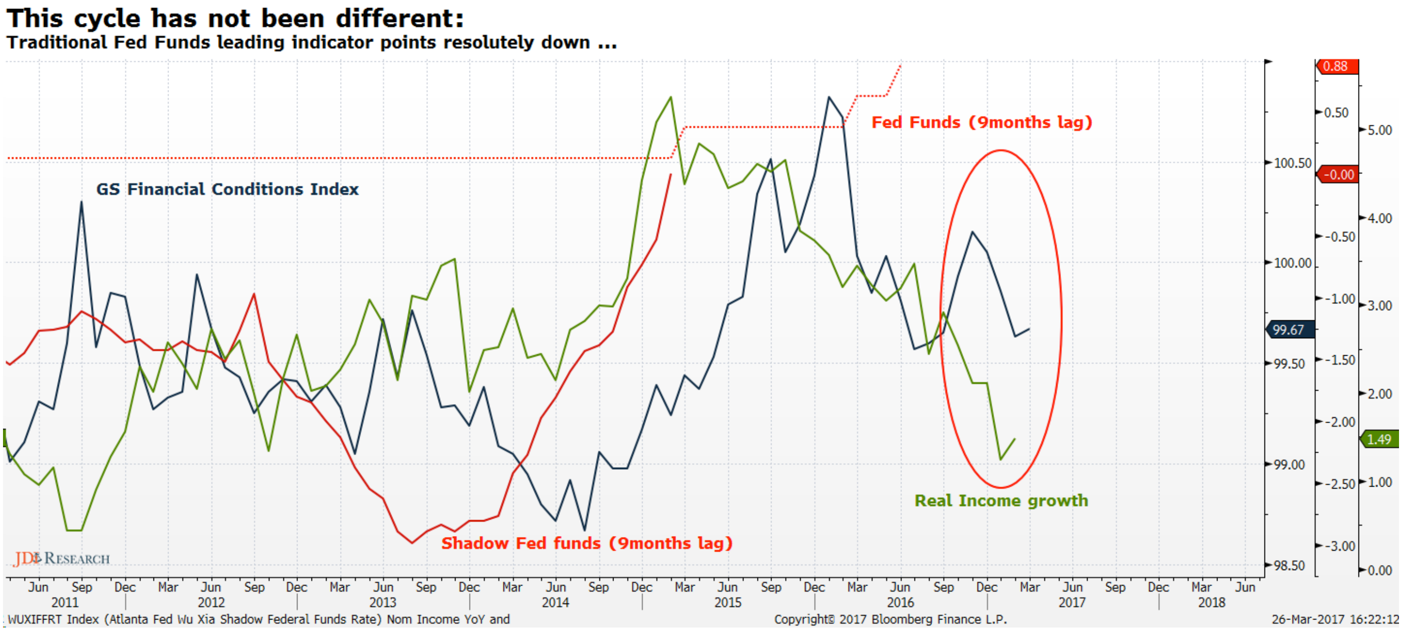
The conundrum in this business cycle? Phillips curve effects have remained elusive. The quid pro quo is that total hours worked has decelerated sharply with the economy reaching full employment without being offset by a sharp acceleration in wages. The result is that aggregate nominal income growth (shown in blue on the below chart) has slid to levels consistent with recession:



With this in mind, it had been no surprise to see income growth leading the ebb and flow of the Fed's monetary decisions historically:



The main FOMC lever over this cycle has been financial conditions rather than the traditional Fed funds (due to imbalanced global growth at the time when Bernanke decided to reduce monetary accommodation) but the Fed's reaction function has been no different:



As such, my narrative this year has been that the so-called “reflation trade” requires a cautious Fed allowing inflation expectations to rise whilst real yields remain stable. The resulting looser financial conditions – in the form of a weaker USD and frothy equity markets - would offset the gradual Fed hikes and allow for confidence and hope to blossom into a strengthening labor market, higher real wages, stronger real income growth, business investment, productivity gains, higher real wages etc.

Following this script to the letter, the Fed has frustrated every market attempt to price a more front-loaded hiking cycle, including over the March hike when it delivered a “dovish hike”.

- **In March, the Fed confirmed its focus on delivering 3 hikes per year in the best-case scenario where the macro backdrop remains roughly stable.**
- **It has also confirmed that the hiking profile was unlikely to accelerate before the effect of the substantive content of Trump’s agenda became observable.**

- **The market's conclusion was that the Fed will not stand in the way of an investment and demand-led shock and will look through potential price and wage pressures to allow investment and productivity gains to blossom into real wage gains, higher potential growth and higher neutral real equilibrium Fed funds.**

Awesome news, isn't it?

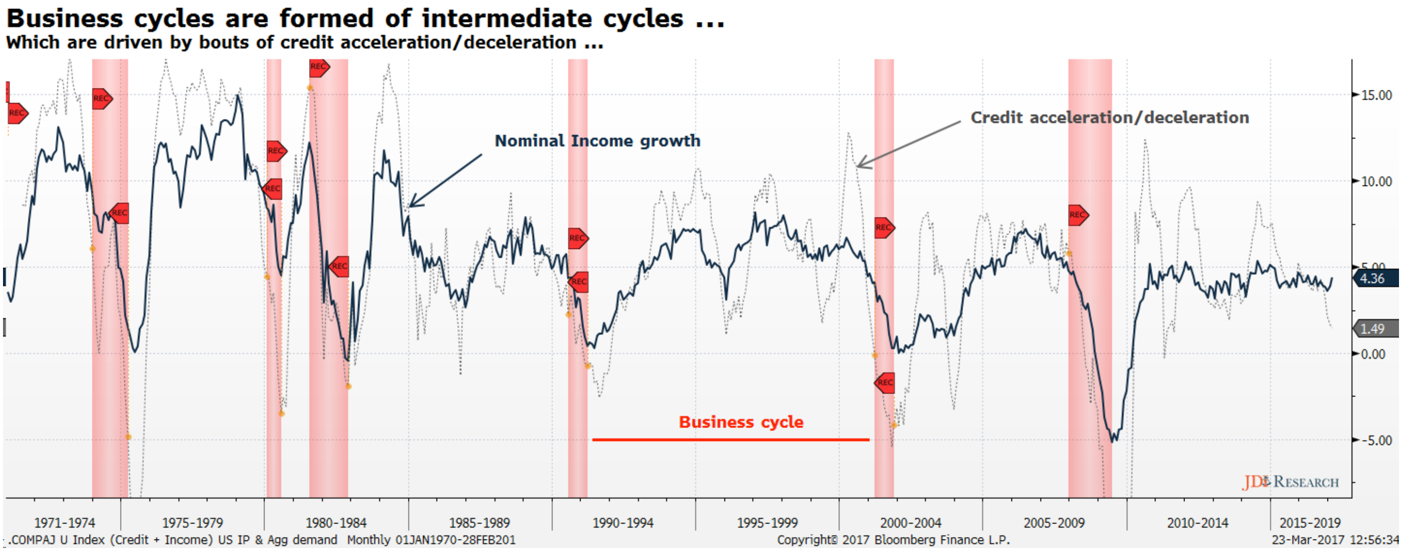
I will develop in this report my view that the Fed – currently perceived to be very dovish – may turn out to be way too hawkish and will need to relent starting now. A central bank's reaction function cannot be judged solely by its absolute willingness to tighten monetary conditions but by its willingness to tighten monetary conditions RELATIVE to the underlying macroeconomic trends. Accordingly, before delving deeper into the in's and out's of the Fed's reaction function, I would like to quickly update my view on the US economy:

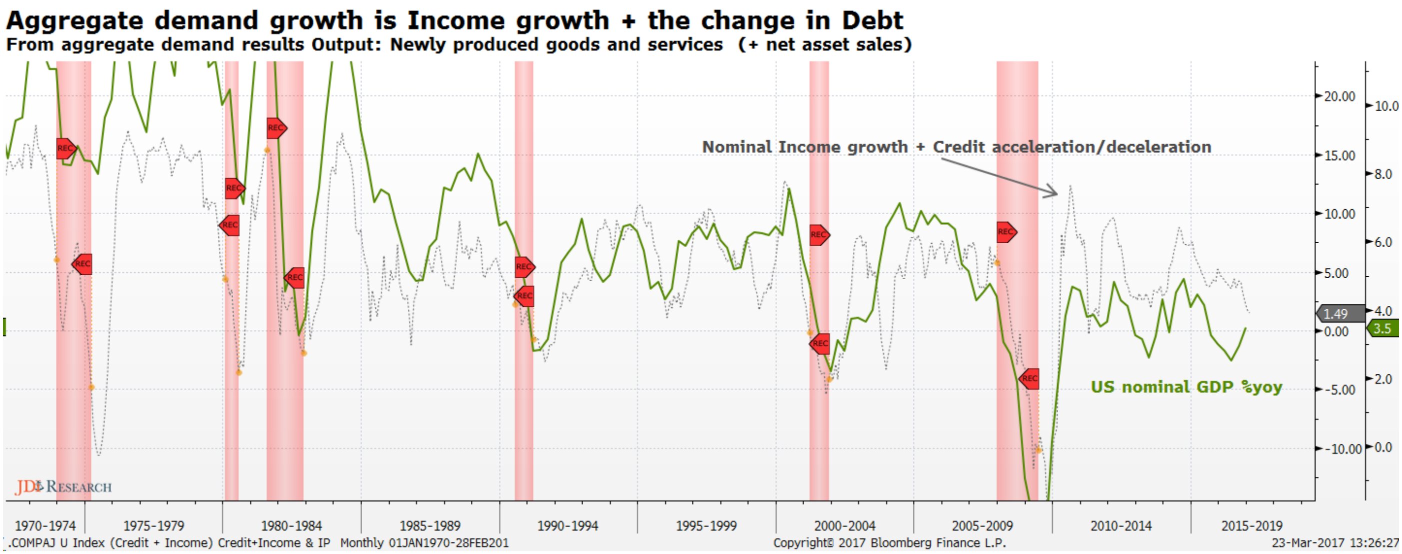
2. US economy: Reality vs Fantasy...

How long can hope support the US economy? How long will Trump have before it is too late…

With the supply side generally unconstrained, capitalist economies evolve to the rhythm of aggregate demand. All demand is monetary and there are 2 sources of money: incomes and the change in debt levels. Because spending is a flow, it should be compared with *net new* credit rather than *outstanding* credit. **The consequence is that credit acceleration/deceleration is what drives aggregate demand NOT credit growth.**

There has been a lot of controversy on this following the collapse in bank lending in the US. **Is credit deceleration the harbinger of a sharp contraction in activity? Or is credit just about to start accelerating on the back of promising confidence surveys?**





The above charts show that income growth added to the credit impulse do define the business cycle and its intermediates.

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- **Historically, ISM has been a near perfect leading indicator for aggregate demand.**

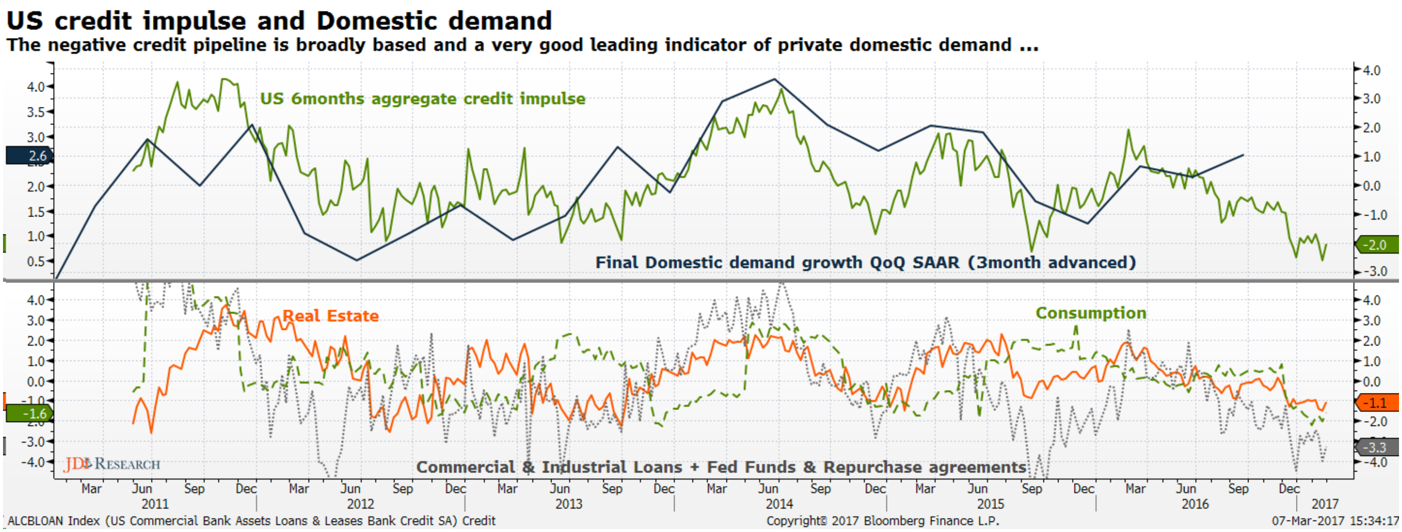
This time it's different:

1) Employment growth has stalled, which is natural with the economy close to full employment but crucially,

2) Wages also show no signs of a pick-up and

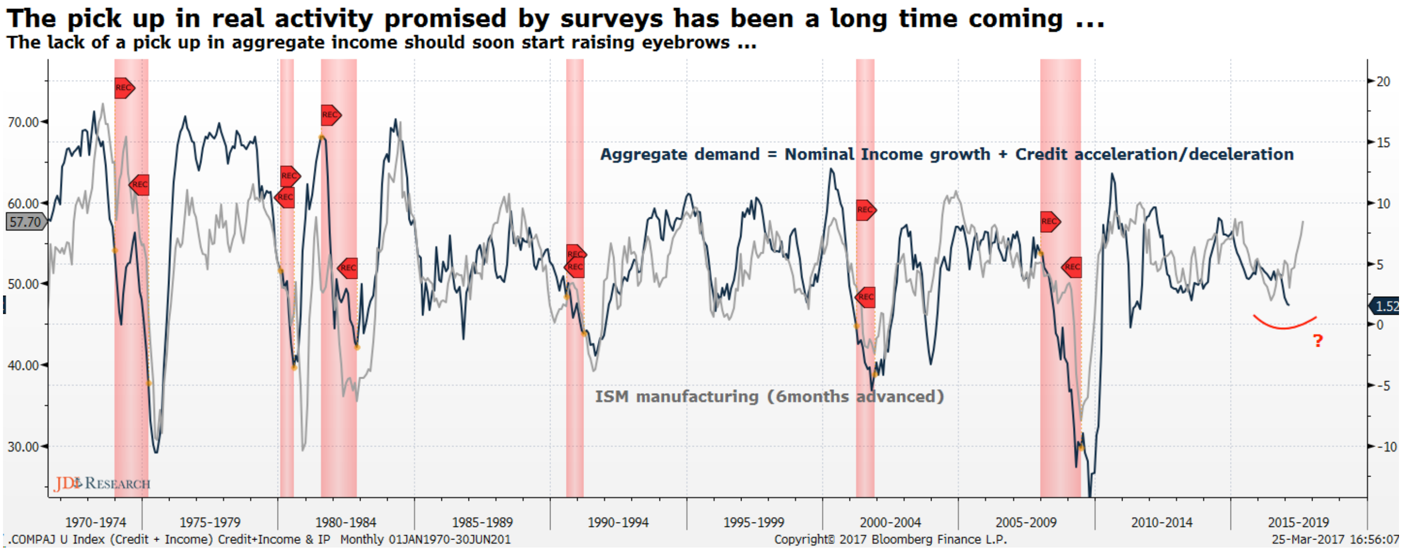
3) bank lending has shrugged off Trump's election and pursued its steep decline whilst corporate bond issuance stagnates.

- **The clear decline in <u>corporate</u> borrowing, combined with the decline in <u>consumer</u> loans is worrying:**



Is it due to the uncertain macroeconomic outlook or already high leverage?

I cannot say. But what I can say with certainty is that Trump's **ambitious tax reform and infrastructure program better be delivered swiftly to stand a chance of jump starting a flat-lining economy or Trump's election will mark the first time ISM lies in its all history!**



The post-election consensus had become that the Republican sweep meant a paradigm shift towards a pro-business environment. However in the past days, the **Freedom Caucus** (which stands for fiscal rectitude, free markets against government control, etc) has shown - with the failure of “Trumpcare” - that it is **willing to use its great disruptive power;** reform paralysis could be the direct consequence as the divide between a populist White House and conservative hardliners in Congress will inevitably re-appear in future legislative debates.

So what now?

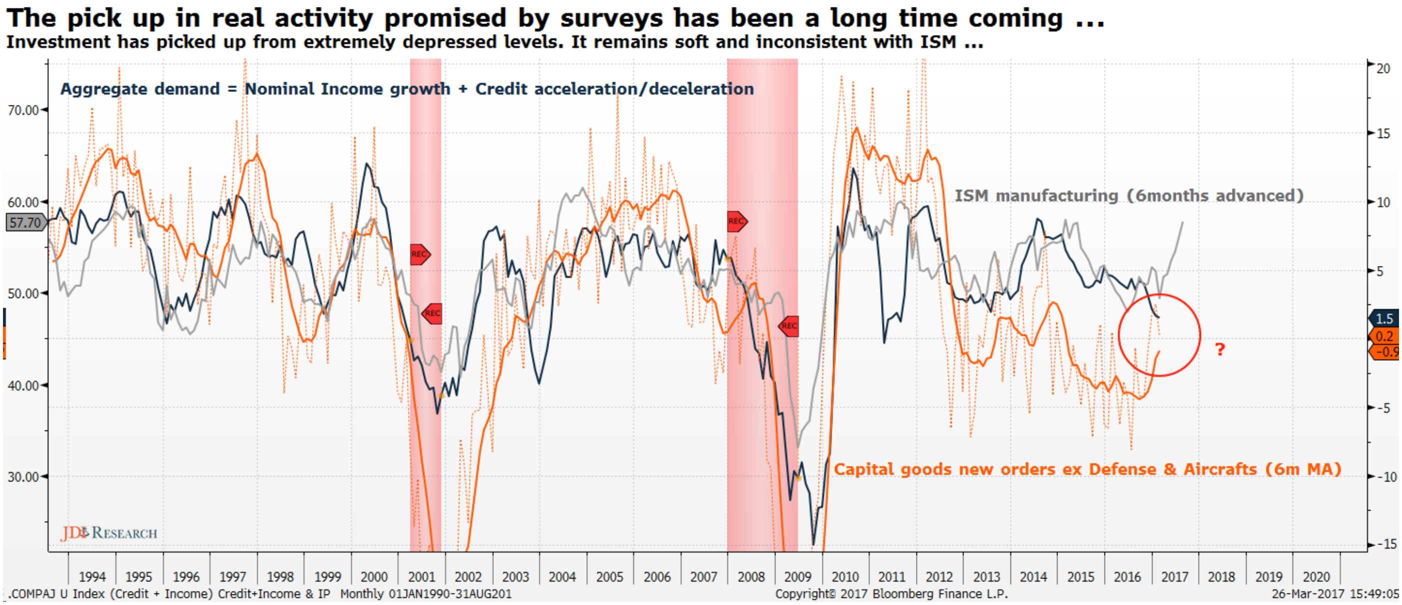
1. Trump's credibility as a deal maker is dented.

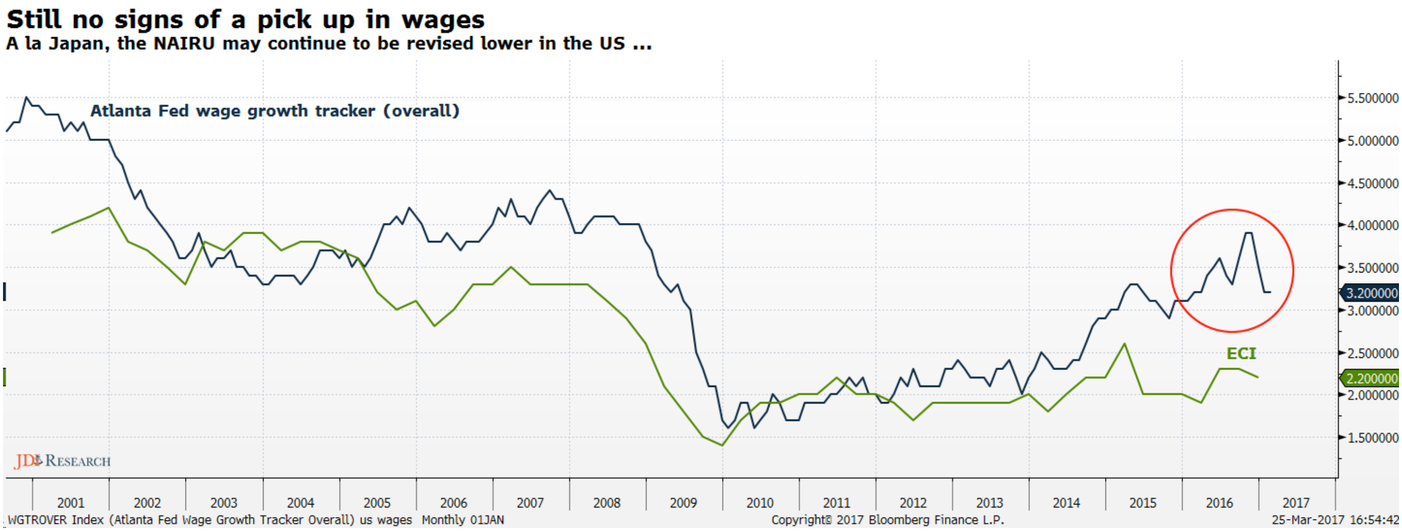
2. Republicans were counting on the circa $1 trillion savings from Obamacare to finance tax cuts.

3. Trump's main political ally in Congress, Speaker Paul Ryan is being scapegoated. He was the main supporter of the Border Adjustment Tax plan (BAT). I also note that Freedom Caucus’ main donors, the Koch brothers, oppose the BAT due to their business interests. Is this a BAT death sentence? The issue there is that the BAT was going to be main source of revenue to offsetting tax cuts. Now that it is

becoming increasingly unlikely to be adopted, where will Trump generate the revenue to finance his infrastructure projects and tax reforms whilst satisfying the Caucus' aspirations of fiscal probity? **All in all, the probability of reform paralysis has greatly increased and the reflation trade is standing on increasingly shaky ground.**

Recent data releases have continued to show ISM as the last one standing:





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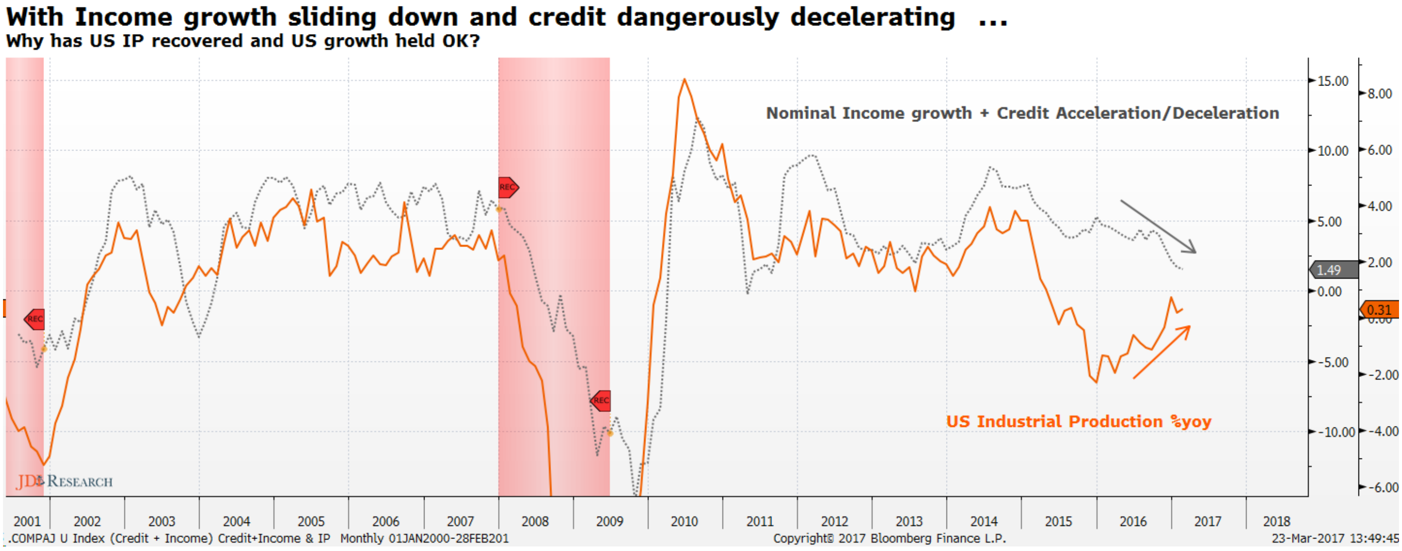
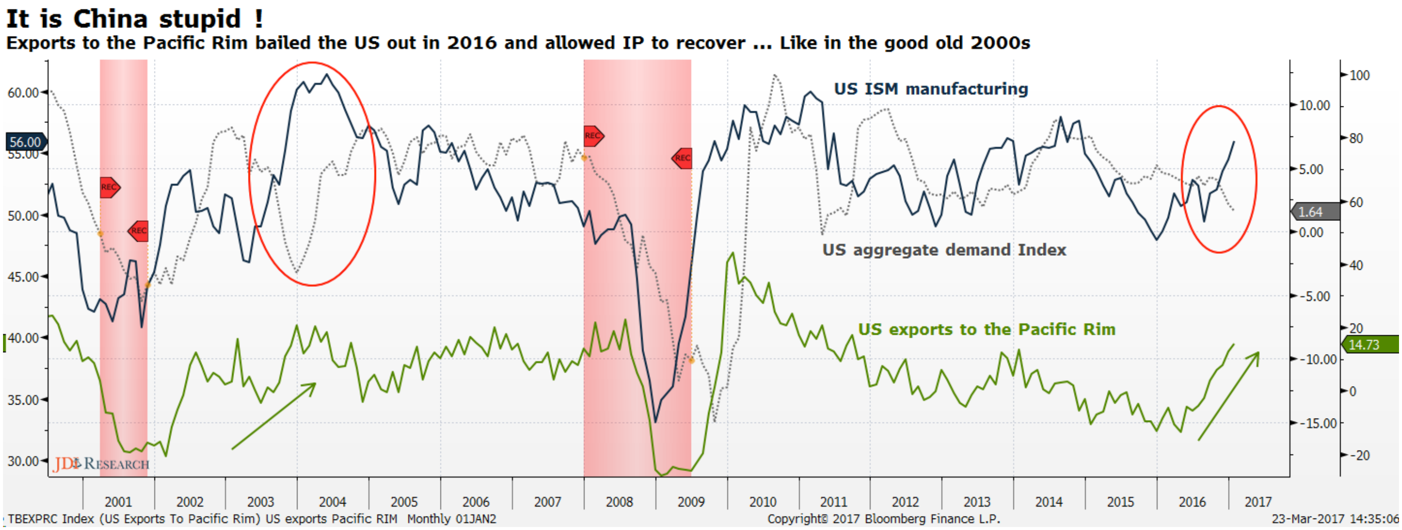
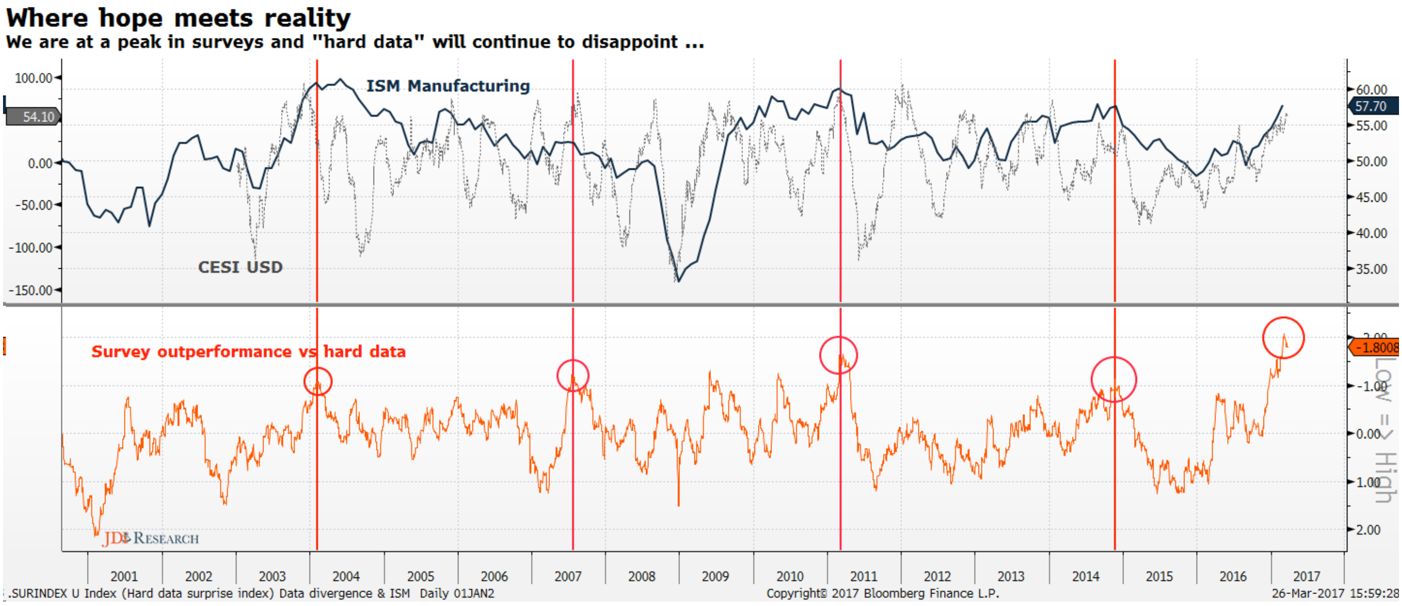
Most economists will extrapolate last year's cyclical upswing and conclude that hard data are only experiencing an inexplicable delay (and that I just need to be more patient):





My fear is that the China-driven early 2016 stimulus, together with strongly positive base effects after the 2014/15 slide in oil and commodities, caused a dead cat bounce in global activity. Trump's campaign promises greatly and artificially amplified the positive survey effect - as herd instincts took over - and created the illusion of a real sustainable cycle.

The issue is that the delivery of Trump's promises may come too little, too late and that China's tailwind is already fading away.



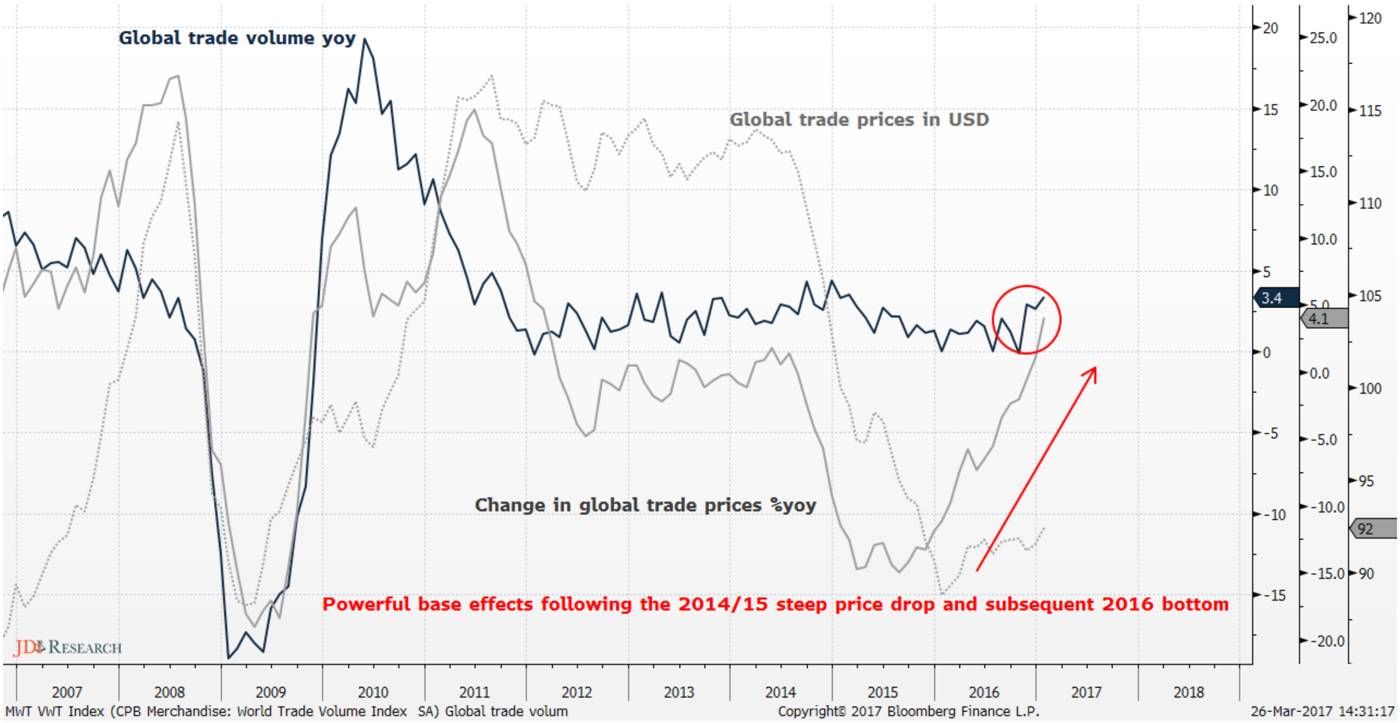
3. US future hangs by a red Chinese thread…

Like fated lovers, both are tied to each other

- **The global recovery in trade, whilst optically pleasing, has mostly been price driven:**

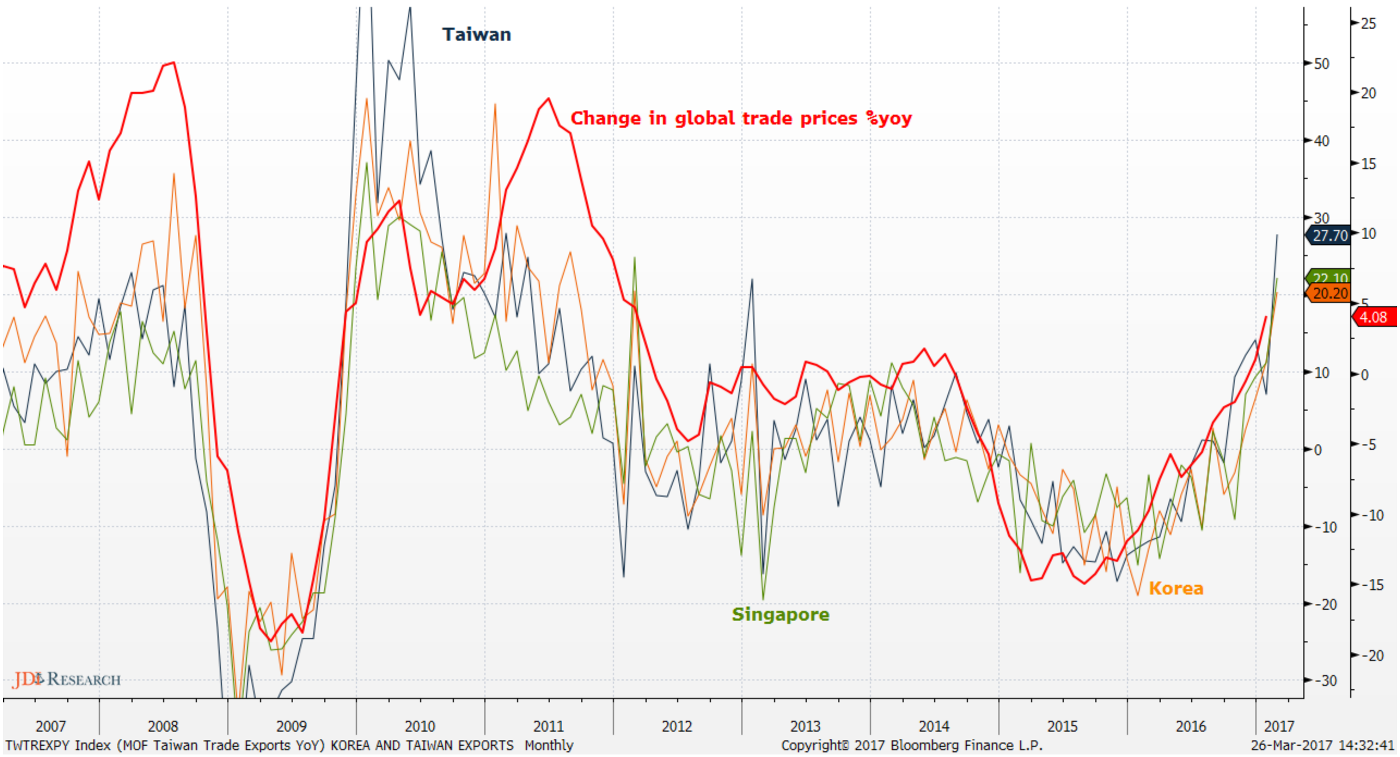
Global trade optically much healthier

But the large pick up stems from base effects after prices bottomed in 2016, volumes remain subdued ...



Korean exports is a bellwether of global trades

Taiwan, Singapore and Korea's exports recovery price rather than volume driven ...



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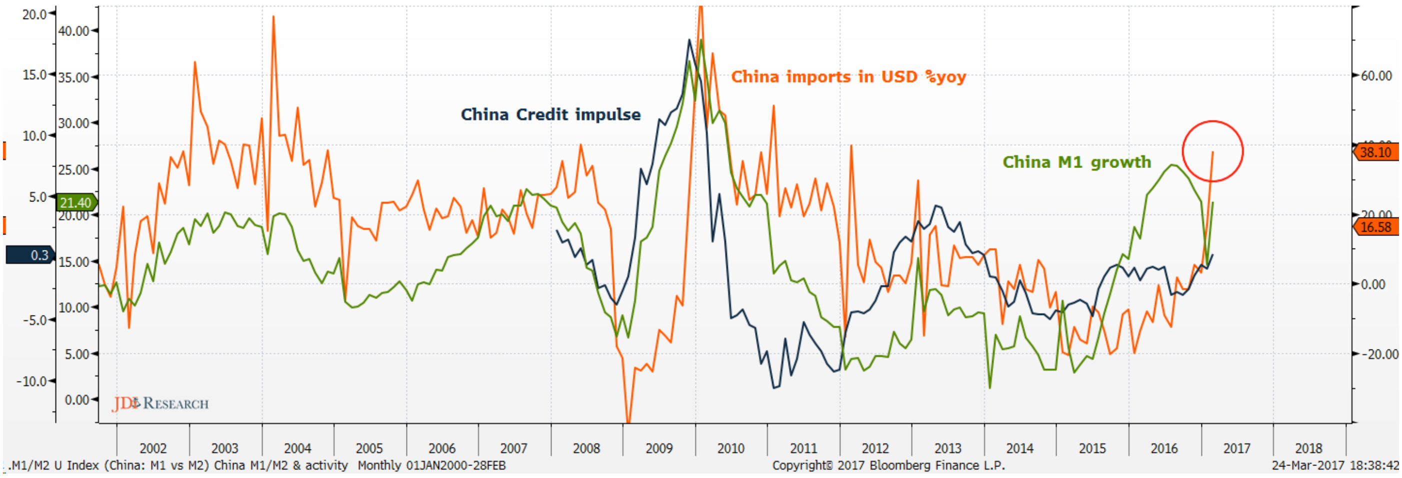
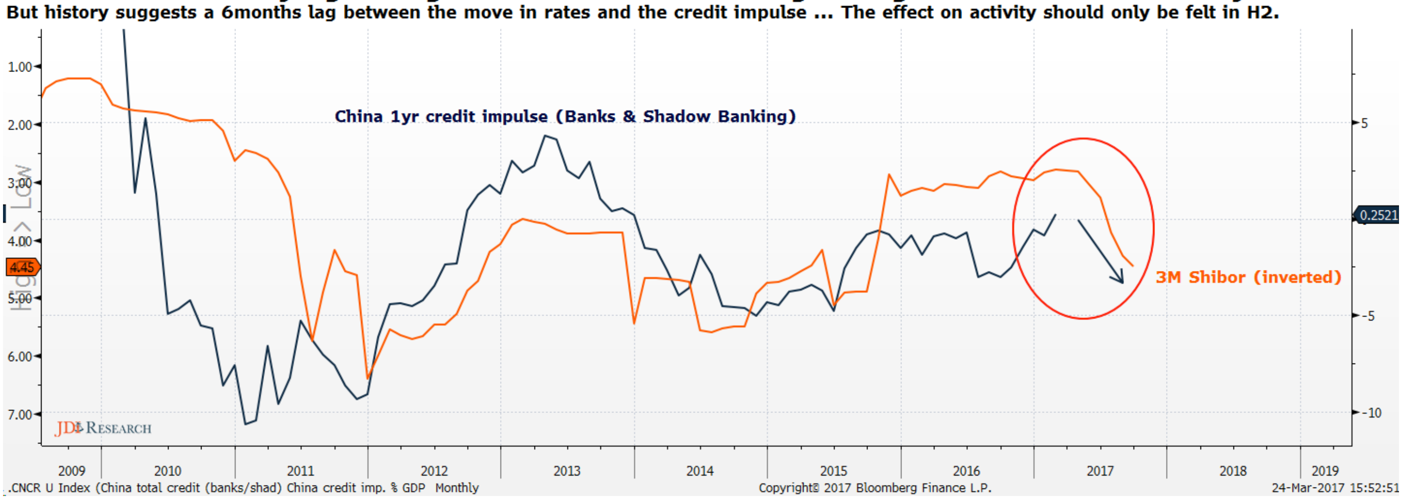
The boost in Chinese activity has greatly benefitted the world
Via a huge increase in imports ...

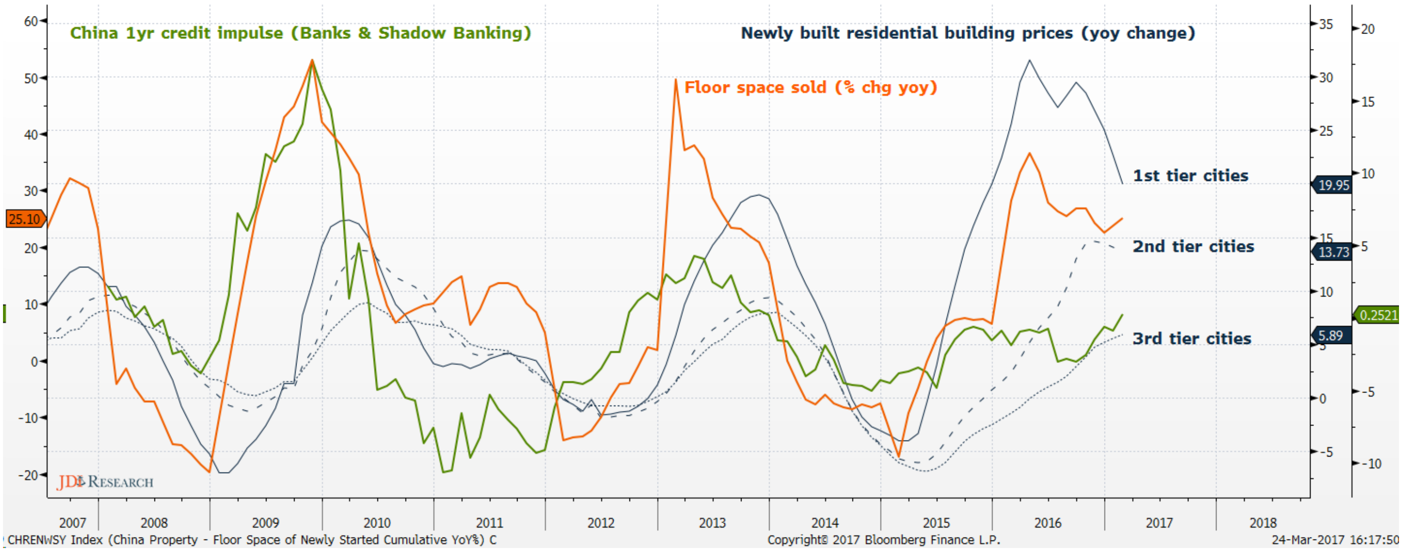


- **There is no reason to call for a China hard landing:**

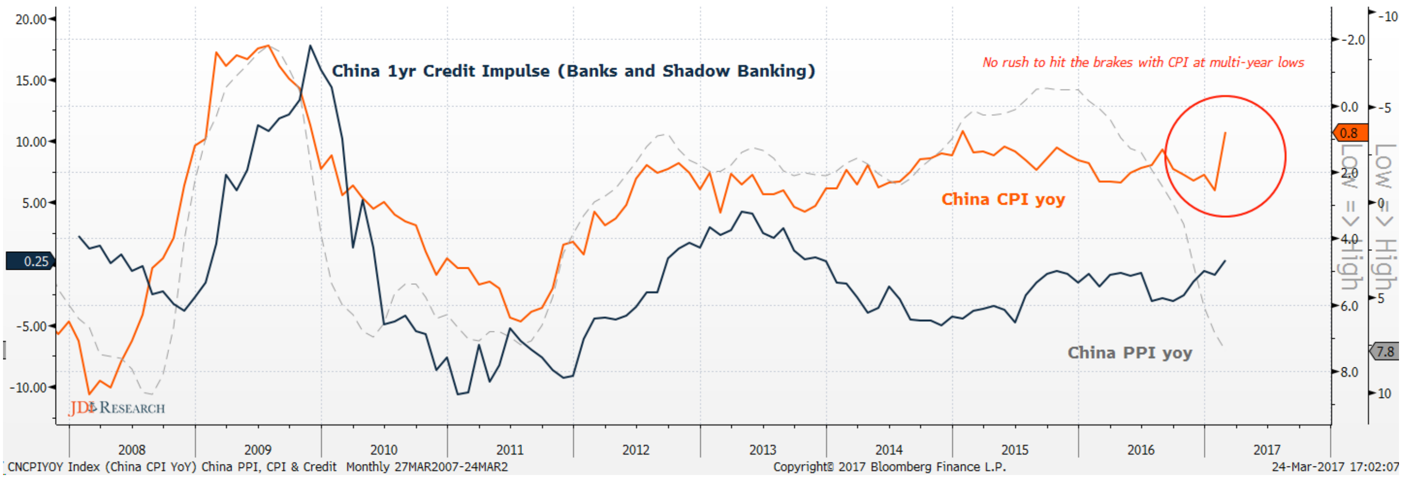
The stealth monetary tightening has meant no effective tightening in credit conditions ... yet
But history suggests a 6months lag between the move in rates and the credit impulse ... The effect on activity should only be felt in H2.



The main risk in China is a burst of the property bubble...
But so far only soft landing can be observed with 3rd & 4th tier cities property prices still supported ...



The divergence between China PPI and CPI means that monetary tightening can remain gradual ...
And focused on financial stability ...



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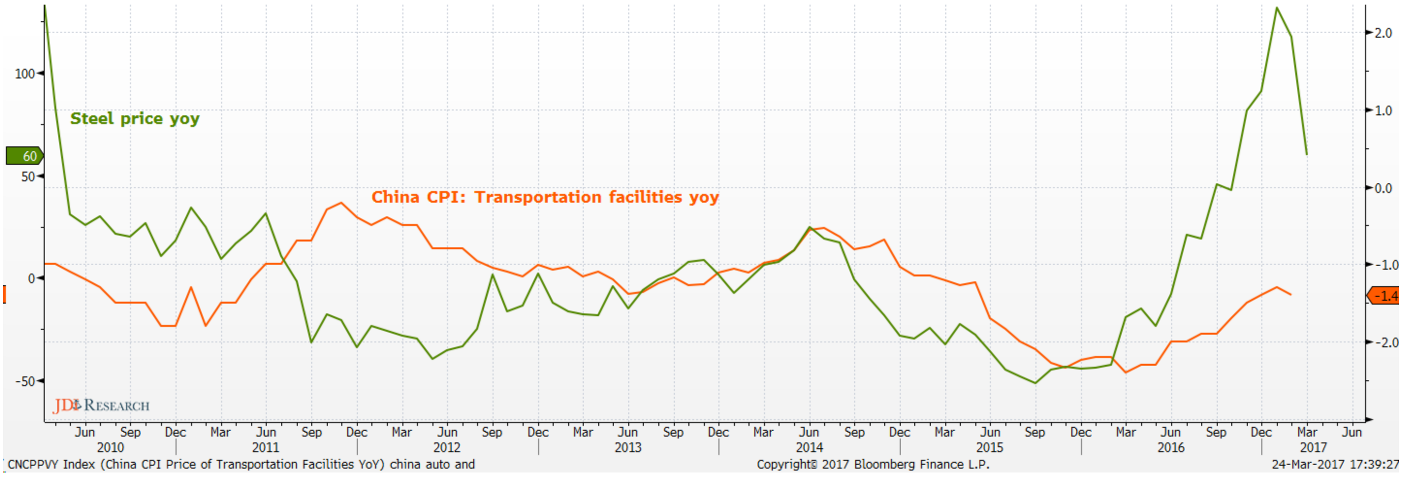
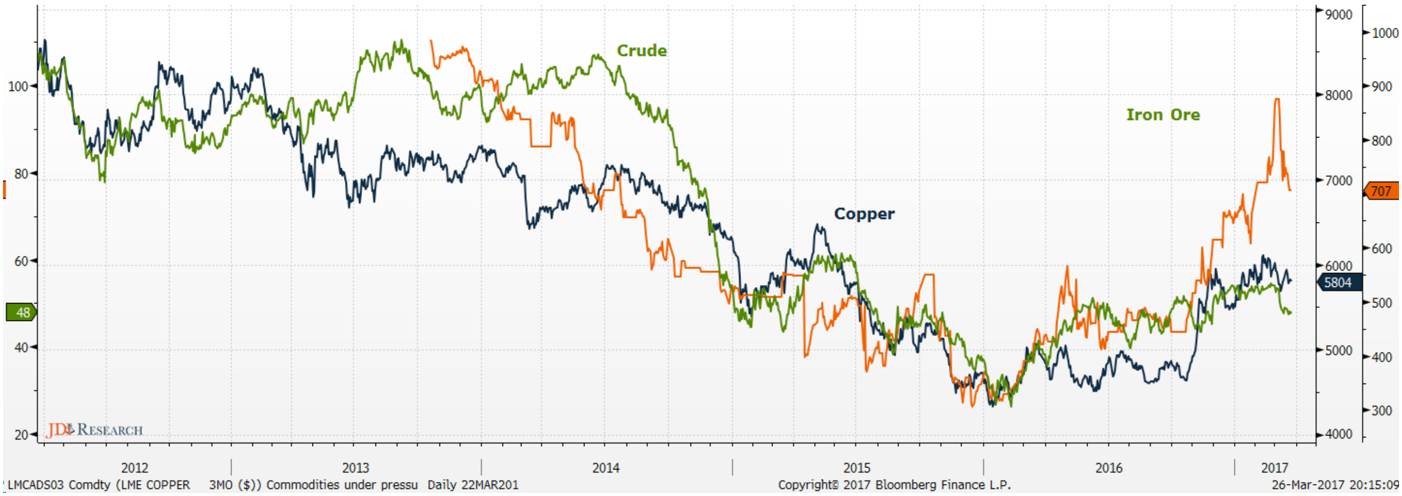
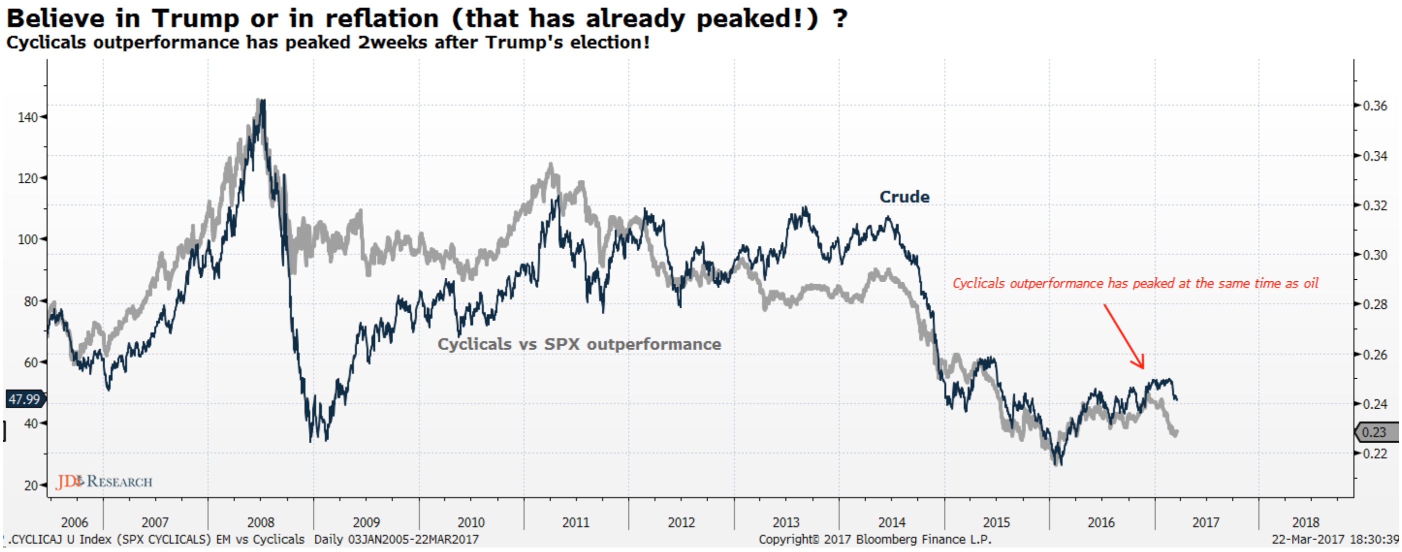
ZERO Pricing power ...
The passthrough between the material purchase price (here Steel) and the output price is negligible ...



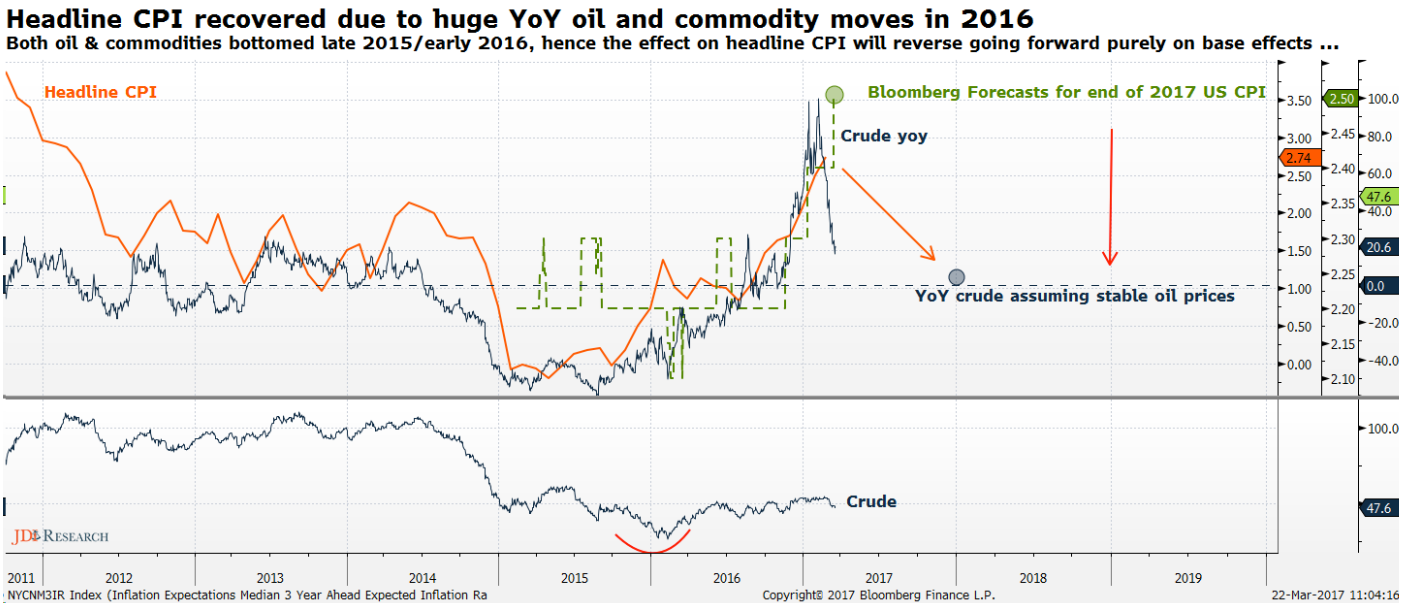
- But the indisputable loss of momentum in activity means that the **2016 price effect is highly unlikely to be repeated.** In fact, **the reflation trade started to fade as early as 2 weeks after Trump's election:**

Commodity prices under pressure...

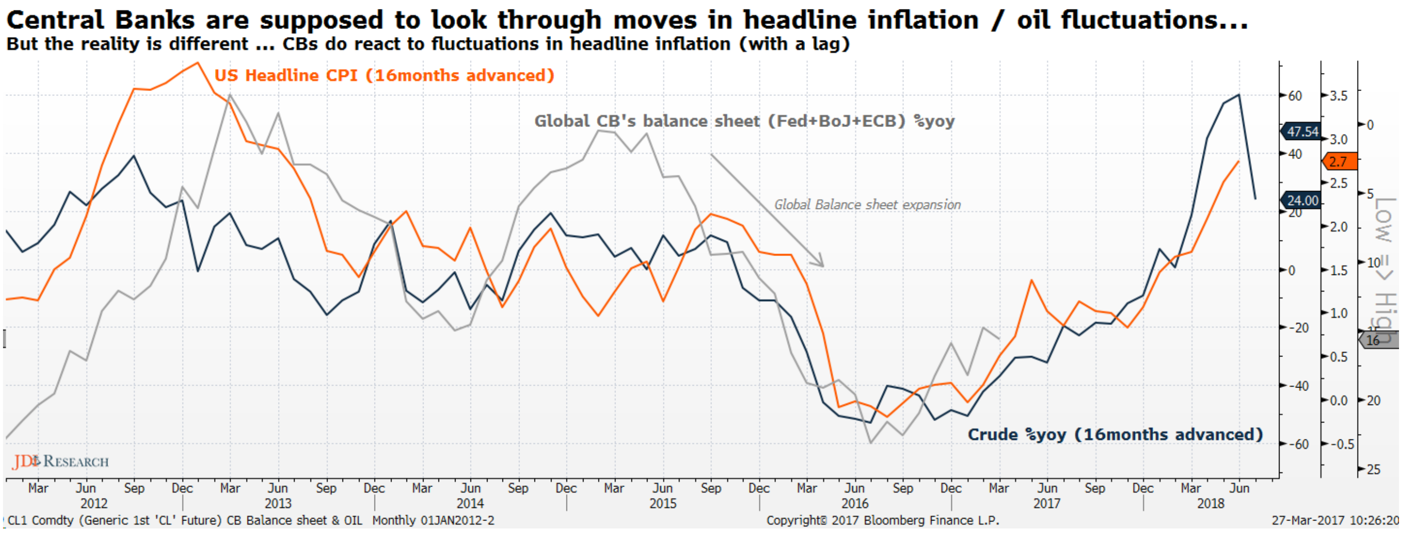




- The problem is that economists (including the Fed) continue to extrapolate the 2016 one off price event to 2017 and assume a more conventional upswing They may be in for disappointment:



- Although Central Banks should not – in theory - respond to oil fluctuations and their effect on headline inflation, they have become increasingly worried about a de-anchoring of inflation expectations and its ineluctable negative effect on core measures. Thus, **it is highly likely that global Central Banks will surprise on the dovish rather than hawkish side in 2017:**



4. Is the Fed truly dovish?

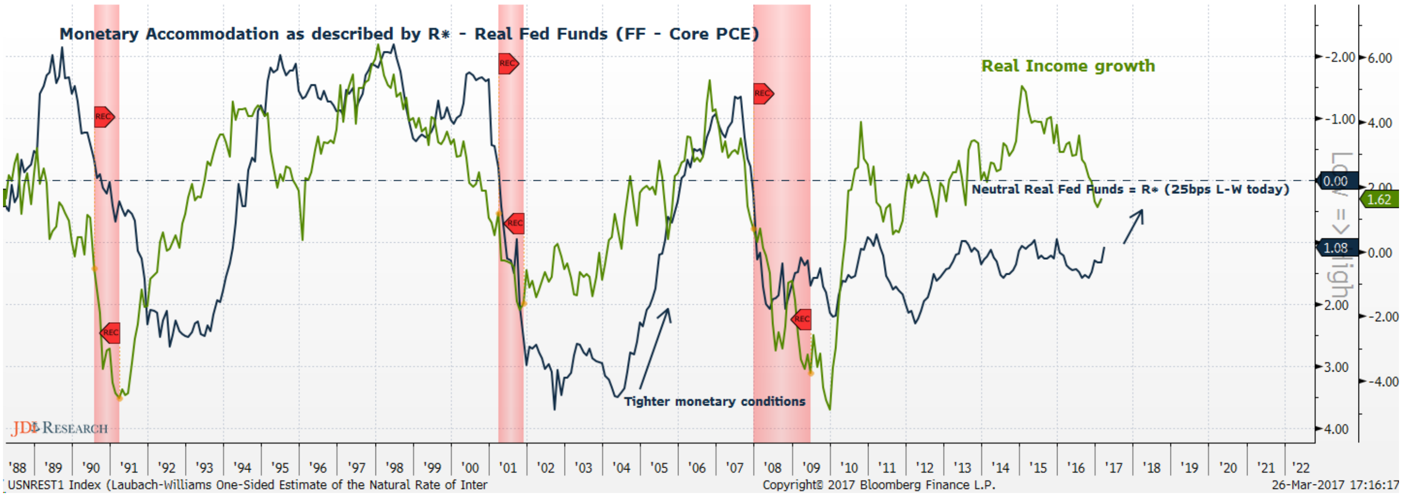
Short answer is NO, but it is likely to be forced into increased dovishness

In the last report entitled "Herd instincts at highs following Trump's election", I have explained that part of my framework consists of weighing the current and historical monetary accommodation as best described by the distance between R* (as estimated by L-W model) and the Real Fed Funds rate (Fed funds deflated by core PCE) against real income growth (which I believe paints the most accurate picture of the underlying macro trends and cycles).

Assuming a stabilization of aggregate real income (uncertain if Trump cannot pass key elements of his program), the updated chart below shows that the normalization process risks triggering a recession even below the neutral level (characterized by real rates at 25bps and nominals at 1.75%).

Real Fed Funds & R*

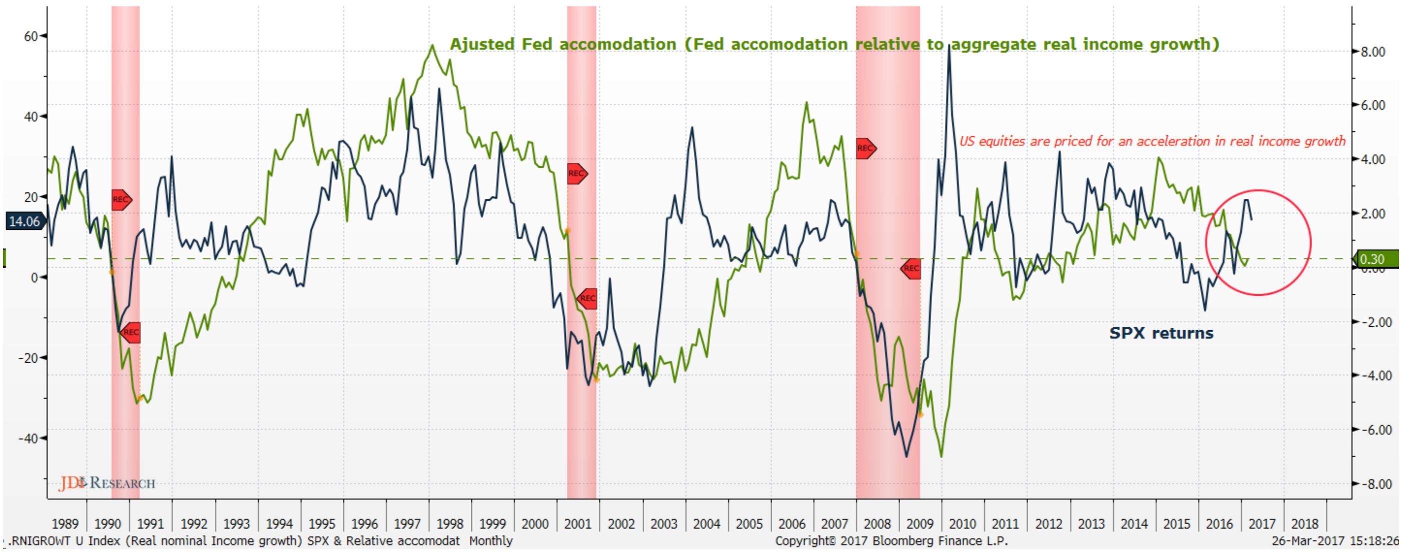
Assuming aggregate real income growth only stabilizes, hard to see the Fed going beyond neutral without triggering a recession ...



My next step was to create an adjusted monetary accommodation index, which is best described as the difference between the current level of monetary accommodation (as above) and the rate of real income growth:

With the Fed leaning against further monetary accommodation ...

The onus is on real income growth to pick up strongly and validate the ongoing optimism on future growth prospects ...



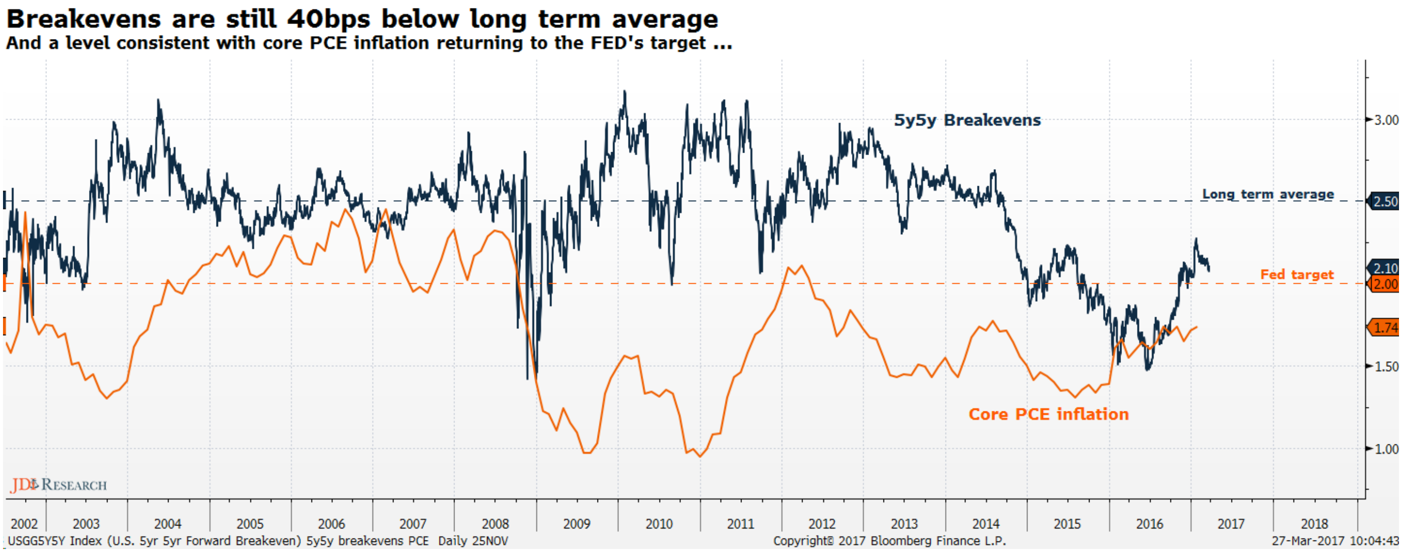
This proprietary indicator has been an excellent leading indicator for recessions as visible on the above chart; it correlates very strongly with US equities performance, the ultimate barometer of the Fed's monetary stance relative to macro prospects.

Here the picture is also crystal clear: **US equity markets are also priced for perfection**. With the Fed leaning against further monetary accommodation, the onus is on underlying macro trends to pick up strongly and validate the ongoing optimism on future growth prospects reflected by soaring soft data.

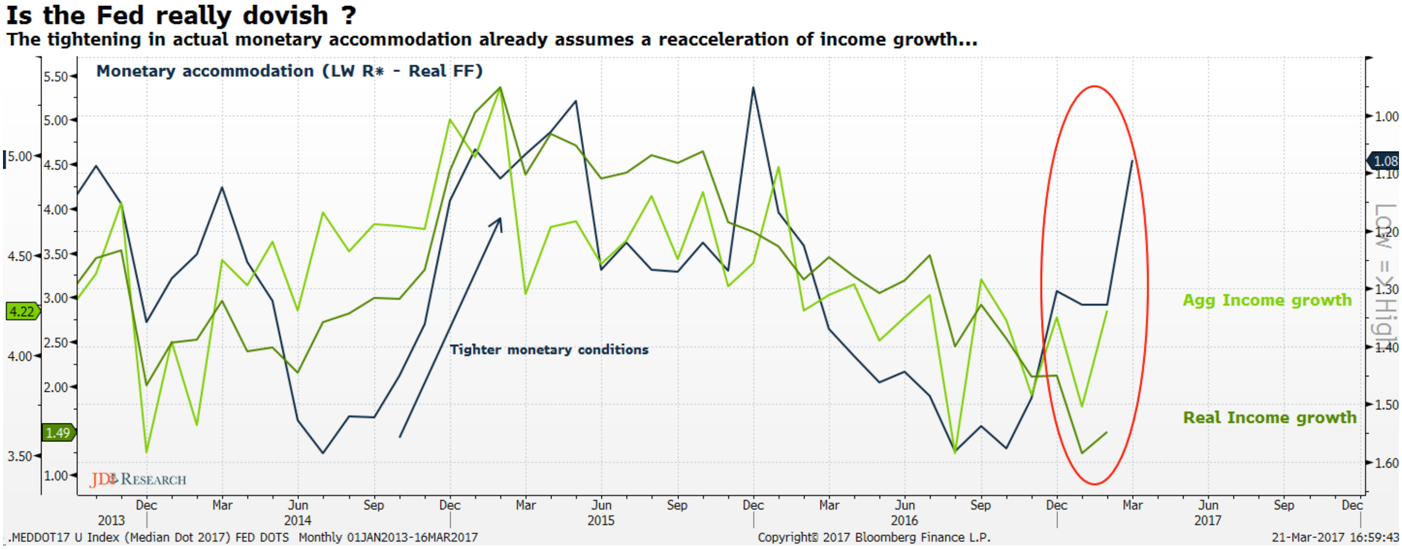
In other words, without the crutch of monetary accommodation, it is imperative for hard data to catch up to soft data or equities risk erasing most of the post-election gains.

With this in mind, it is legitimate to question whether the Fed is truly dovish:

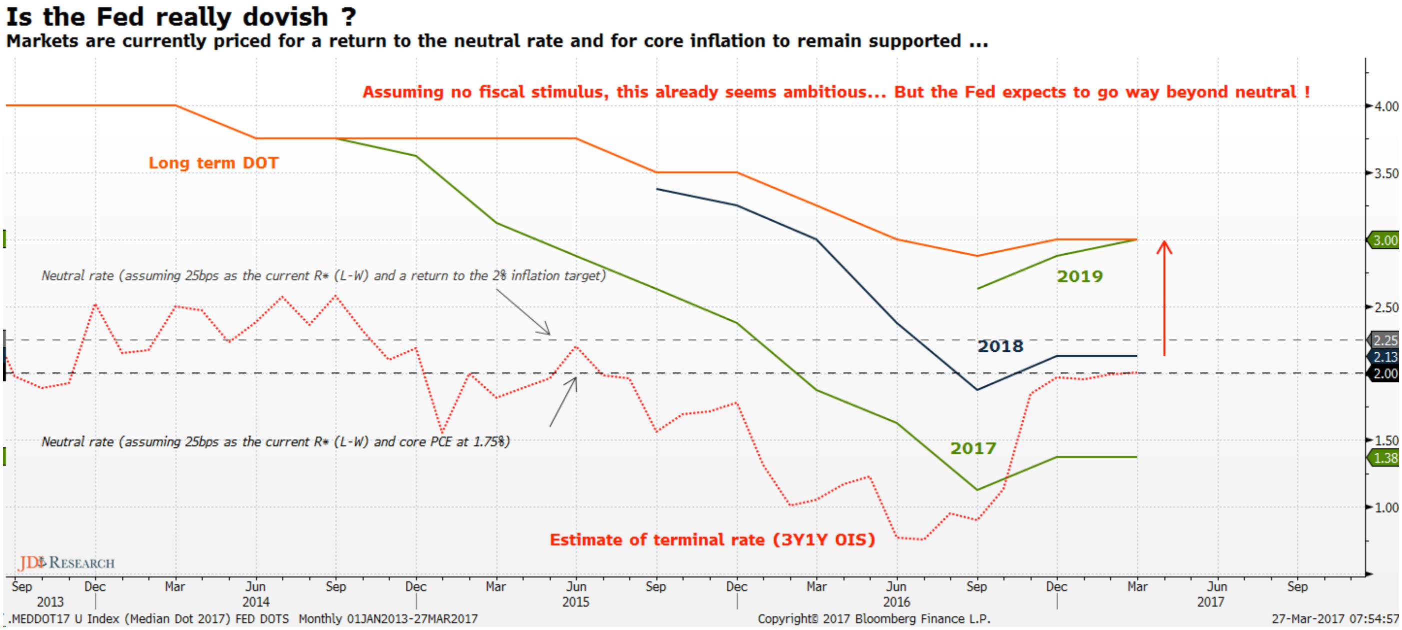
1) **Breakevens are still inconsistent with a return to the Fed's inflation target:**



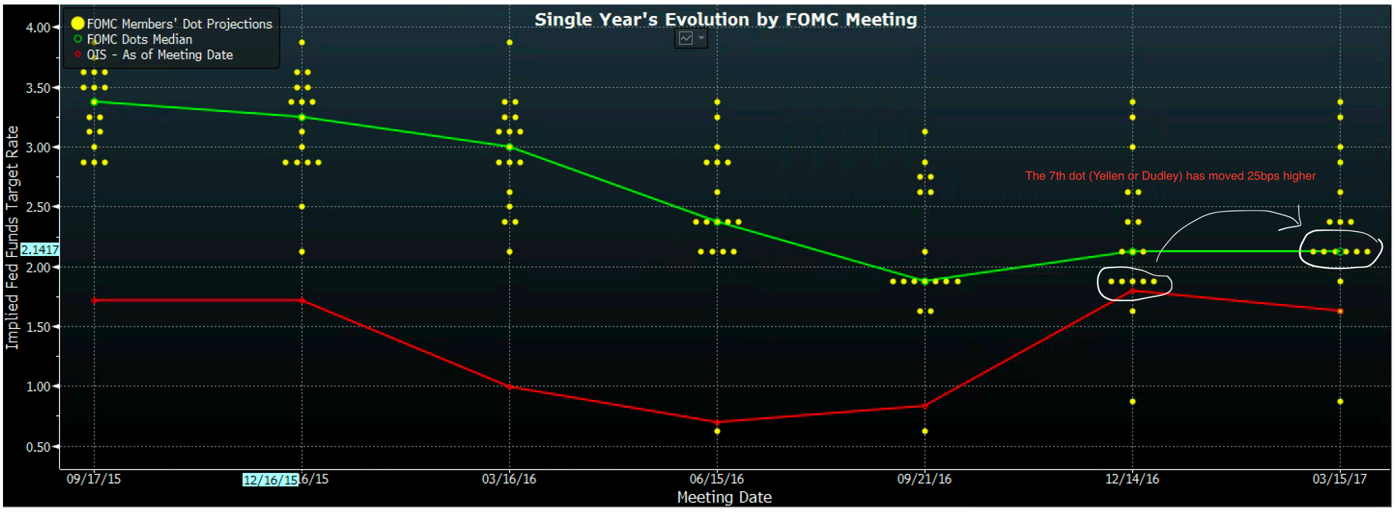
2) **The ongoing tightening in monetary accommodation pre-empts a re-acceleration in Income growth:**



3) The Fed assumes no fiscal stimulus, yet the median dots assume a return to the neutral rate by 2018 and a sharp move beyond neutral (or a push higher in R*?) by 2019! This is in fact rather hawkish…



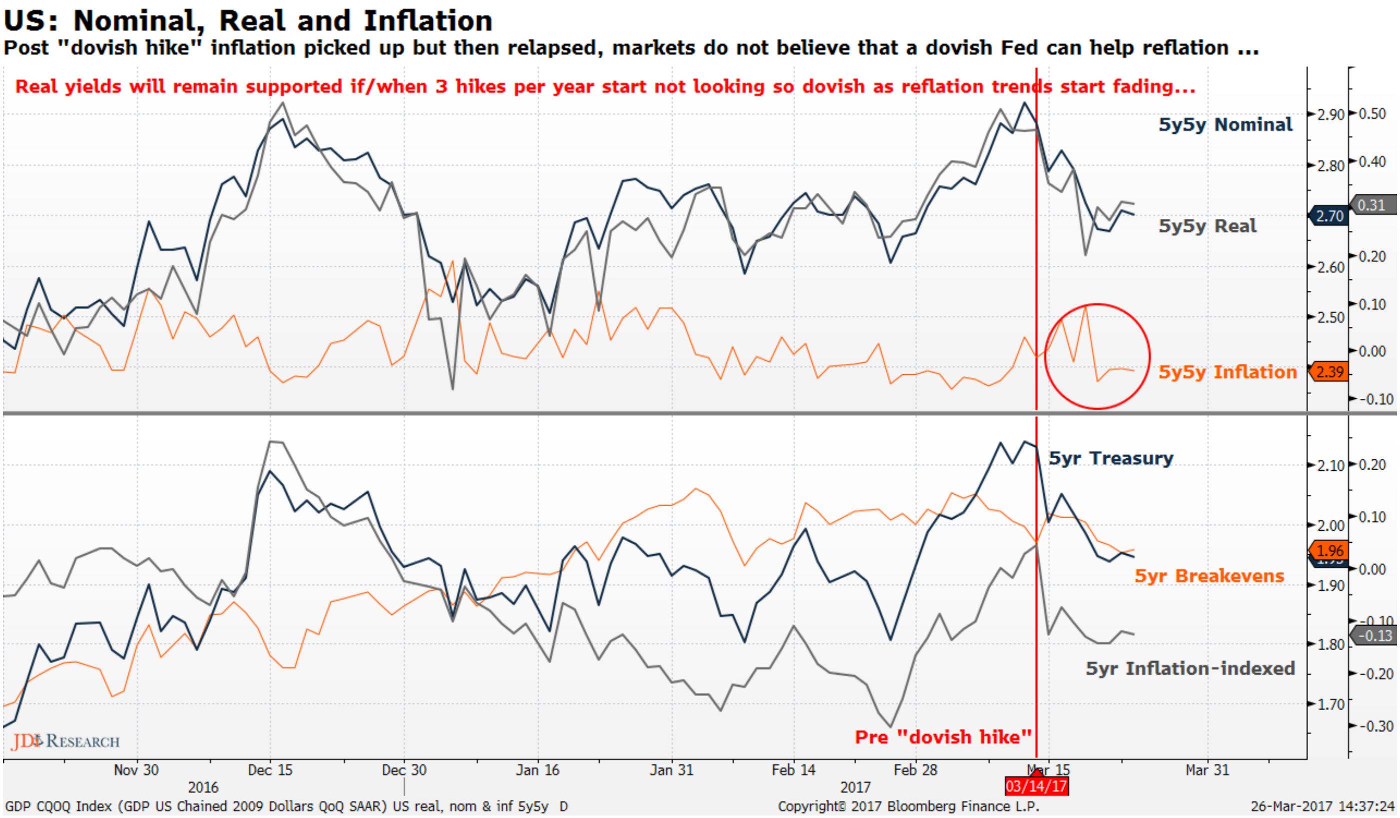
4) The last straw on the camel's back is that the consensus around this bullish scenario increased at the last meeting: The 7th dot (which most certainly belongs to Yellen or Dudley) moved up 25bps for the 2018 outlook:



To summarize, although the Fed may continue to sound hawkish, there is currently no room for it to ACT hawkishly (and outdo market's expectations). The Fed was dovish at its March meeting *relative to markets expectations* but it was not dovish relative to a gloomy macroeconomic reality. It is easy to see the Fed get more dovish but it is more likely to be out of necessity, in order to avoid tripping US growth over. Indeed, the last hike has shown that the Fed is uncomfortable with letting financial conditions loosen further**. In other words, nominal rates will accompany lower inflation expectations rather than trying to get ahead of falling expectations.**

➔ The market implication is that nominal rates will fall driven by lower breakevens. This is a radical change in the "Trump trade" when the Fed was expected to stay put and let breakevens pick up in line with the global upswing. **The former dynamic allowed real rates to decline, whilst the latter will keep real rates supported. This means that the USD will stay on its back foot but mostly led by the lower yielders like EUR, JPY and Gold. Risk should also be in a topping process in the US. And the US curve will continue to flatten despite the so called "dovish Fed".**

The gap between fantasy and reality has widened further this week and the bulls' arguments were dealt a further blow in the wake of the Fed's "dovish hike": Following a short-lived rally, inflation breakevens faltered and all reflation trades have continued to show signs of cracks. The loss of momentum in assets prices predicated on a continuation of the upswing is keeping markets increasingly nervous. **The increased probability of reform paralysis is only a small part of the "stagnationary" camp gaining ground.**

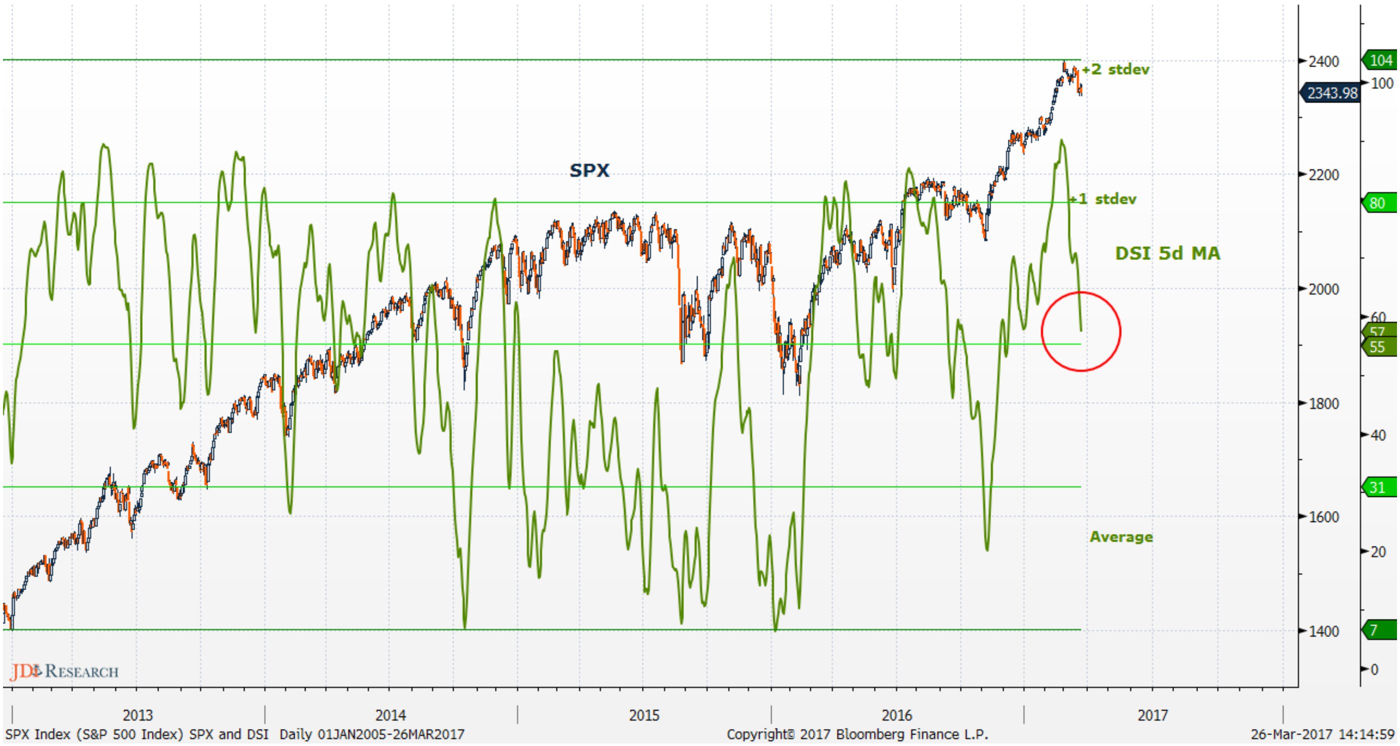


5. Markets implication…

Markets are only starting to question the herd's narrative…

Sharp turnaround in sentiment towards the USD

Quick turnaround in sentiment towards equities but bearishness can increase

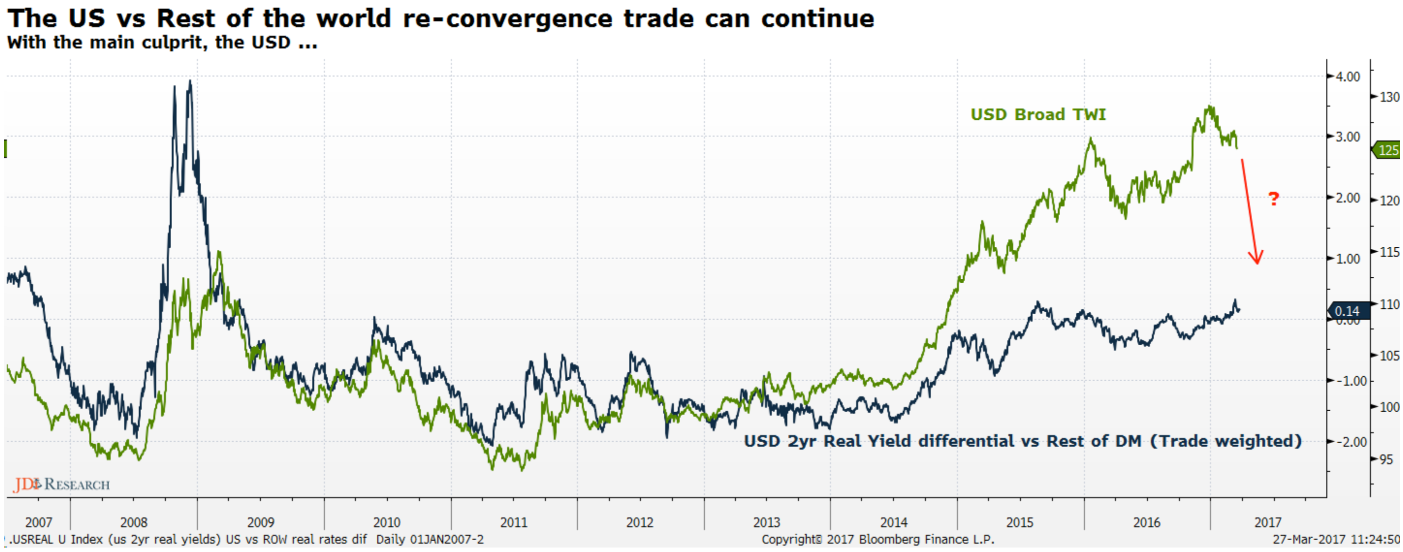


Sentiment towards 10yr treasuries remains depressed

Long EM has become a strong consensus

➔ Going forward softening leading indicators added to disappointing releases on the hard data side will prove a **strong headwind to risk assets that have fully priced a strong improvement in underlying macroeconomic conditions relative to the level of monetary accommodation.** However, equity sentiment has already retraced in 2 weeks from 90+ to 50 and the fixed income rally I expect could keep assets supported on a continued risk premium compression**. I am recommending staying short US equities (SPX/Russell) but with tight stops to protect profits. I will consider taking profit on the beta part of the position by recommending buying European stocks vs their US counterparts.**

➔ **The fading of the China tailwind is unlikely to be felt profoundly before 2017 H2. The fact that the fate of the US economy depends mostly on China's tailwinds means that the US vs rest of the world growth convergence trade can continue to best express itself with short USD.** Unless Trump delivers on fiscal promises, we are unlikely to see the Fed act more hawkishly. In fact, the balance of probability strongly favours a continued repentance of over-optimistic projections. I have recommended taking profit in the long EUR & JPY trades I favoured in my last report (2%+2% profit) but mostly due to the high correlation with long 10yr Treasuries and short US stocks. I will look to re-enter EM FX vs USD but the fact that real rates have probably troughed means that the easy trade is now behind us and that levels should be picked carefully.



➔ My **strongest view is long US fixed income (10yr).** I have initiated the position at 2.60 before the last FOMC and recommended adding on the break back inside the consolidation triangle at 2.45. I note that sentiment there remains strongly one-sided and that there is ample room for consensus to become more balanced or even turnaround. Positioning has become less extreme with CTA's beta almost back to flat but other metrics suggest that short positioning remains substantial.

To conclude:

- The ISM pickup that started thanks to China's macroeconomic tailwinds and exploded following Trump's election gave **the illusion of a real sustainable upswing.**
- I think **the herd may be delusional and that extrapolating last year's reflationary trends to 2017 is an error.**
- **The Fed's projections are unrealistic** if Trump fails to pass the macro-economically substantial elements of his program and risks lie towards a continuous Fed relent after 2 consecutive rate hikes.

- The most likely scenario is that **hard data will disappoint: The China-driven reflation theme has most likely ended and growth headwinds are tremendous going forward in the form of a negative credit pipeline.**

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The above is only meant to be a roadmap to help CIOs navigate risks more safely. Specific levels and trades can be discussed separately on BBG or phone.