Juliette Declercq: U.S. Election Outlook, U.S. Dollar, Real Yields and more.

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Erik: Joining me now is JDI research founder Juliette Declercq. Juliette has prepared a slide deck to accompany today's interview, registered users will find the download link in your research roundup email. If you're not yet registered at macrovoices.com, just go to our homepage, look for the red button that says looking for the downloads right above Juliet's picture. Juliet, it's great to have you back on Macro Voices, it's been too long. Now, I know we usually talk about Europe and some of the things that you specialize in but I also know from reading some of your work that you're actually focused primarily right now on the US presidential campaign. So, tell us a little bit about what your prognostications are, what do you say? It's great to have an outsider's perspective on what we can expect in this election.

Juliette: With the Covid crisis fading away in the United States, I was not surprised to see Trump catching up to Biden. After all the ace up his sleeve is the economy. Of course, its not my personal opinion because I think that short-termism and obsession for rising equities and financialization will cost the US economy greatly in the long run, but I have no vote in this contest.

Clearly, his trademark persona is that of a businessman who can drive the economy back to prosperity rather than bankruptcy. Undeniably, the reason this year's events have not permanently damaged Trump is the V-shaped asset recovery so you will not hear about firing Powell for a while I think ☺.

There is a bigger question mark here though. Because jobwise, we have only recovered to the worse of the Global Financial crisis with y/y hours worked still down 7.5% y/y.

Will Americans look at the Nasdaq's all-time highs and their lack of jobs and realize they have been duped all along?

If you have a continued slump in equities into the elections, I think it would be game over for Trump.

Economically, e.g. in real life, the issue we have today is that additional unemployment benefits were withdrawn faster than employment could recover with the end of additional unemployment benefits at the end of July. This is literally threatening to pull the rug out from under the hardest hit after the Covid crisis. The risk as you will see on chart 1 of my chart package is that we end up having income expectations converge to the level of unemployment and a deflationary loop. Instead of employment converging to robust income and demand expectations, which is the only path to a continued recovery. This is a circular issue well illustrated on my chart; income subsidies remain essential at this point for sustainable recovery.

If you consider what is happening in Europe: Germany agreed to lengthen its job protection program (covering 87% of wages) until the end of 2021; France has also introduced a furlough program that could last up to two years; and Spain extended its furlough scheme indefinitely. The lack of a fiscal cliff has allowed consumer confidence to slowly recover. Despite the fading of the coronavirus crisis, it has not been the case in the US, I believe the expiry of the Cares ACT employment subsidy is the issue. Of course, Trump promised a $300/week benefit (vs $600/week before) by executive order, but this is only a short-term bridge and a flimsy one at that. It is absolutely crucial for Trump (and markets) to see consumer confidence rise from here.

Some will of course argue that it's a double-edged sword because keeping workers on a drip alleviates short-term pain and boosts confidence levels, but it also delays the necessary reallocation of labour resources. I would agree that it is a very fine like but the key here to my view is that it is way too early to pull the plug on employment subsidies when employment has just recovered to the worse of the Global Financial crisis.

Erik: Juliet, so why have the republicans not yet folded on the next relief package?

Juliette: Perhaps Trump is complacent because he really believes that the new equity market highs accurately mirror the state of the economy. In this case a compromise on the relief bill – somewhere between 1 and 2 trillion – may be just around the corner given the recent tightening in financial conditions. The other possibility is that he will wait until just before the elections to send the second round of cheques to households signed with his name.

It is also possible that he does believe that the executive order fills the fiscal gap until 2021. But this would be a miscalculation because short-term delays in payrolls taxes (on which by the way companies are reluctant to cooperate) and an extension in wobbly employment benefits (where states lack the firepower to deliver) pale in comparison to the 5 to 10% fiscal stimulus necessary to drive the US back towards full employment. If this is the case, it will cost him the elections.

Erik: So, it sounds like you're 50/50 on the outcome here, no real clear view as to what's likely to happen.

Juliette: You know…. I spent considerable time studying polls and digesting the best political analysts' research. My conclusion is that the election is really too close to call. My best guess is that if Trump ends up accruing the benefit of a fiscal relief package then it's really 50/50.

Perhaps more importantly for markets, which after all is my job… I am not looking to call the election but to call markets OVER the elections… It may be controversial to say this given how polarized the population is in the United states … but my belief is actually that neither potential president is a short-term game changer. What I have learnt through years of experience analysing underlying macro trends in relation to markets is that macro almost always wins over politics, especially in Developed Markets. Political events generally creates noises and offer opportunities but they rarely are medium term market drivers.

Think about it, the truth is that both candidates want a fiscal stimulus, they just also both want to own it. Therefore, reflation is very much the name of the game whoever is elected – perhaps even more so if financial conditions tighten. That's because the remedy to an equity rout will be biased to the fiscal side now that the Fed is largely just a liquidity façade. This is the reason my "A" trade remains paying 10yr US breakevens.

They have been trending higher since I recommended the trade at 1% at end of march. Against conventional wisdom, fixed income has not become a dead asset class but one where you really had to embrace trading TIPS or real yields this year to express a macro view in the fixed income asset class.

In short, Trump is more friendly to corporate earnings. That's potentially great for equities short-term but the lack of aggregate demand risks stopping the recovery right in its track, which will eventually be an issue for assets. Biden stands for social stability and redistribution. It would greatly benefit aggregate demand in the long run but potentially justify increased volatility in the short term on higher corporate taxes and increased regulations. The risk with Trump is a return to trade wars eventually, which would also include Europe and slow the USD slide, stopping the global recovery in the process. But this really is tomorrow's story; he will avoid tariffs at a time when the economic recovery is so fragile. Conversely, Biden would lower the world's geopolitical temperature and accelerate the recent cyclical recovery through further fiscal stimulus, further widening of the US trade deficit and a much weaker USD.

I guess the perfect market outcome is Biden at the wheel with a Republican Senate.

But what really matters just now is that the US – and the global economy – are still gaining momentum with central banks heavily focused on increasing asset purchases. This is the main message I want to get across.

Erik: Juliet, I wanted to start with your perspective on the elections. But what I'd like to do now is describe my own perspective on it to you and get your reactions because something I'm finding very interesting, I guess I see this differently than most analysts. The vast majority of smart people that I follow are saying something very similar to what you've said today, which is, boy, this is hard to tell the outcome in terms of what it's going to mean for markets at this point, because it does kind of look 50/50 in terms of the poll odds. I see it very differently; I think there's about an 80% certainty as to what the outcome is going to be. And the outcome that I'm talking about is the one in which almost everybody in the United States is in agreement that their candidate won the election. Not should have won, but did win, my guy one and anybody who says the other side won is trying to undermine democracy, and that's fighting words, and I'm not going to stand for it. So, what I see and I don't see how we could possibly avoid it is a situation where you have almost everyone certain that their side won, neither side is willing to concede. And you've got everything tied up in a major supreme court battle between Election Day and Inauguration Day and nobody is sure who the President is or who the President Elect is. Now, that's obviously an extreme view but frankly, I think it's pretty darn clear that almost has to happen. What am I missing or why wouldn't you see that is the likely outcome and if you do think it's a possible outcome? What would it mean for markets if I was right?

Juliette: Well, I tried to avoid this question because it's indeed a difficult one to answer. But you are absolutely right, it's on most of my clientsminds. Indeed, with such a close call, my understanding is that Trump may win on the night but because a much larger proportion of Democrats vote by post compared to Republicans, there is indeed a really high chance that nobody consents on the night or even right up to Inauguration Day. And I completely agree with that with you on that, inevitably, we will see a rise in violence, some even talk about the risk of Civil War, which will be a grave problem. Especially given, I've just explained how, confidence is such a crucial key to the outlook and violence with them with inevitably undermine confidence and jobs in the prospect and bring back the spectrum of a deflationary loop. So this is important, of course, and it's key to a continuation of the recovery. All I could say that I'm acutely aware of this and the risk is on my strategy radar. This is another reason to probably add a long volatility hedge to my portfolio of recommendation. There is no question that there's a chance that the US election is an inflection point this year in global assets. However, the one thing I would like to really say here is that in my framework, such riots would be more likely to be the spark that starts a global fire. In other words, they would not be a game changer, unless they came in tandem with a worsening global cyclical outlook. And on this, what are we really be looking at is the Chinese credit impulse, German IFO export expectations, the OECD division index, they all tend to lead the global cycle by a few months and they are still shining a green light. Well, if I'm starting to see those in this is like showing the way to a loss of momentum into 2021, combined with riots in the US, that would certainly, you know, make me much more conservative on assets and, you know, potentially could turn everything from inflation to deflation. So, in other words difficult to call from here, but it's clearly something that you need to have on your radar, especially if it's combined with a loss of momentum globally.

Erik: Well Juliette, it sounds like from what you've said here and also in your prior answer, the one thing that we can probably agree on is regardless of which president is elected, or even if we're not sure which president is elected, one thing you can probably count on is we're eventually going to get to some kind of fiscal package. So, what would stop a vicious cycle from developing where lower confidence leads to higher unemployment in the short term? And if we're going to potentially have a pause before we know who's president then that gonna delay that fiscal package that maybe allows even more time for a vicious cycle to get started, what are the potential consequences of all this?

Juliette: In terms of looking to "who has my back?" in the meantime, well obviously the Fed is there in terms of helping Wall Street even if it has largely lost its potency to affect Main street. The deluge of liquidity has already considerably loosened financial conditions and this is something you know and can observe for yourself on Chart 2.

The Fed's shift to Flexible Average Inflation Targeting or "FAIT" and its associated de-emphasis of the NAIRU is a revolution. A paradigm shift away from more than two decades of monetary policy.

In a nutshell, the Fed is moving away from a rules-based reaction function to a more discretionary one with past inflation "misses" and employment "shortfalls" becoming the whole equation. Practically, this means that the Fed is looking to overshoot its 2% inflation target whilst ignoring Phillips curve effects. Theoretically, this should avoid a repeat of past Fed pro-USD policy mistakes when monetary policy was tightened pre-emptively, tanking inflation expectations and any chance of hitting the 2% inflation target in the process.

This shift should also mark the end of the USD upward trend and mean that real yields easily reach -2% or even -3% in a recovery and that financial conditions will continue to ease.
But there's a catch; the Fed is increasingly impotent to affect the real economy. What's the point of having an inflation target and moving it around if you are no longer the master of inflation's destiny?

And that's where the Fed's newly found flexibility will greatly matter. Thankfully in this cycle, the "trickling down" theory is no longer the only one in use. The real macroeconomic earthquake is that fiscal authorities have plugged this hole by "going direct" or "people

QE"… I have called this Casa de Papel, with loans to small businesses and direct financial support to households. The fed has really just become a liquidity façade and that promises fireworks and a swift macro revival. Think about it, we previously had central banks all moulded in the same school of thoughts in charge of the underlying macro trends. This power has now been transferred to politicians because they are the ones controlling spending. Central Banks are now just in charge of monetizing – or not. Needless to say that the Fed's new flexible framework is a gift from the gods because it will be greatly needed to respond to politicians' tantrum… The other consequence of a sharp increase in economic interventionism where fiscal policy drives underlying macro trends is much greater volatility in the whole system. One can no longer take financial stability as a given and be complacent, forget risk parity funds and their reliable yearly gains. Central banks independence will eventually be threatened as gvts inflate their debt load away or … they may get their hands tied eventually by much higher inflation prints, having to raise rates and crash assets in the process. You will not get smooth portfolio returns and should not even assume that they are possible. Passive investment should in my opinion be relegated to the past: be in charge of your investment process, invest in your education, understand every drawdown. This is my main recommendation. The macro landscape has changed radically.

Erik: Well Juliette, thanks for your political and election perspective. Let's move on now to the US dollar and asset class that you've done a lot of work on and made some really excellent calls on in the past. I got to admit, I'm completely baffled here because I can make a very strong macro argument for why the dollar should appreciate with flight to safety trades and so forth. We've got a global pandemic, there's a lot of good reasons to be dollar positive, except for you know, little minor things like the impending threat of a civil war in the United States, which I certainly don't think is a high probability outcome, but it's actually a realistic possibility for the first time in my life, is this dollar positive or dollar negative or dollar volatility or what?

Juliette: So, the USD outlook fits almost perfectly into my inflation outlook. What will drive the USD going forward is the Fed and US fiscal authorities ability to debase the USD through higher inflation. As I like to say as a central Bank you can't just talk the talk but also must walk the walk. The Fed is the only DM central bank with the ability to just do this by breaking the link between forward US interest rates and the outlook. This is an unprecedented break you can observe for yourself on chart 3 of my package. The ECB or the BoJ did not have this luxury to keep the curve flat because their respective yield curves were already as flat as a crepe before the crisis. The second thing is that even if European countries finally got their act together in issuing Eurobonds, thus unlocking the fiscal side, we still have the so called "frugals" dragging their feet. What it means is that cooperation between US fiscal authorities and the Fed is potentially much more powerful and potent in terms of generating inflation than their counterparts in Europe or Japan. It is no surprise to hear Fed members scrambling to call for forgetting deficits for now.

In short, that means that US real yields may well collapse further possibly towards -2.5% - 3% eventually and that the ECB and BoJ will much better preserve your purchasing power, not necessarily because they want it but because they have no other choices.

The last thing I would like to add is that the one who have called the USD right this year are mostly now recommending to take profit, whether because the ECB will resist the move or because the the adjustment has happened. It is the wrong way to look at things because the USD is a momentum animal. You can see on chart 4 that the USD's upside momentum has collapsed and this is a game changer. The USD is an object in motion that stays in motion because it's the world's reserve currency. Basically, that means that a dollar move is self-reinforcing and it gives change in the trend a staying power. Why? Because the USD is involved in a large majority of transactions globally so a USD decline increases global liquidity and loosens financial conditions abroad. Especially in Emerging markets where funding vulnerabilities improve linearly with lower USD prices. We also get Commodity prices getting a boost in the process, thus raising global prices. And domestically import prices increase. The USD is a heavily countercyclical asset (chart 5) so the looser global financial conditions improve the cyclical outlook and also weaken the USD.
So to the question of whether Christine Lagarde was "soft" on pushing back against EUR strength and USD weakness, I would reply that it is completely the wrong narrative. She was soft pushing back on USD weakness because she knows that global financial conditions are much more important even in Europe than domestic financial conditions. In other words, a broad USD slide is much more beneficial to European growth than a one off 10% Eur devaluation. IN other words, I think the ECB's failure to answer to the recent EUR appreciation is intentional and part of what we may see in a few months called Plaza Accord 3. The USD slide has only just started.

As far as stocks are concerned, even after the recent 5 month rally I still do not see valuation as an obstacle to much greater gains. What I think though is that we need a broader leadership for the move to remain sustainable. This rally should rotate to become more centred on cyclicals and non-US stocks because relative valuations are completely out of whack with my view of a strong cyclical and earnings recovery into 2021. If you add to this my view that real yields may well fall much further thus keeping multiples elevated, I think the greatest risk is perhaps to be too conservative into the election because of higher volatility and get caught naked e.g. having to chase financial assets higher. But I really want to repeat here that this view could change quickly because we are headed to a much more unstable macro environment.

Erik: Juliette, I want to come back to what you said about US real yields possibly collapsing further down toward minus 2.5 to minus 3%. Give us a little bit more colour both on when you say real yields. Obviously, that's the nominal yield adjusted for inflation. What kind of nominal yields are you talking about? Say the US 10 year going negative and that's how we get after inflation to that minus 2.5? Are you saying inflation grows to the point where positive yields on a nominal basis still result in a minus 3% on a real basis because the inflation is running higher than 3%?

Juliette: So what I'm talking about is basically nominal staying kept by whether it's going to be QE, whether it's gonna be YCC, or whether it's going to be really strong forward guidance, which I expect will be announced tomorrow. So literally 10-year yields kept below 1% and I really see real yields collapsing on inflation going higher. So if you just get the Fed manage to overshoot its inflation targets, we're talking about potentially like 2.5%. So that would basically take, real yields down to 2%, but obviously what they want is actually to overshoot. So you could get to 3% on 10 year breakevens, with like nominals still below one that takes you closer to 3%. And obviously all I'm seeing and I can't show you all my charts here. But what I'm seeing from the end of this recession is much stronger inflation trends than we have seen in the past, which is really completely in agreement with my view that the micro landscape has really been revolutionized. And that's really on the back of central banks not being in charge anymore, but governments and obviously that's the door button to overshoots.

Eric: Juliette before we close, I know that at JDI research you primarily focused on institutional clients only when I first met you, but I know you've actually got several high net worth families and family offices who are Macro Voices listeners that are now subscribing to your products. So, tell us a little bit more about what you do who it's for and what's involved.

Juliette: Yes, I founded JDI research five years ago now. What will actually be really interesting this year is you can see a much increased interest from high net worth and I can certainly see that a lot of Americans particularly are at home ensuring that their retirement is going to be sufficient. So there has been a move away from just institutions to more personal advisory, what I do really is publish reports that help you navigate markets with very specific recommendations that have been quite successful. And I'm quite proud to see that my framework is continuing to produce exceptional returns. If you want to get in touch, you can reach me at juliettedeclercq@jdiresearch.com or you can visit jdiresearch.com website and contact us through there. As usual, I'll make a small effort of an offer for Macro Voices listener and that's something I only do once a year. So really, all I can say is get in touch to see from if our interest can converge.

Eric: Juliette, thanks so much for a terrific interview Patrick Ceresna and I will be back right after this message from our sponsor.