Juliette Declercq: Why Equities Stand On Much Stronger Ground Than Consensus Seem To Believe

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Erik: Joining me now is JDI Research founder Juliette Declercq, who is perhaps best known for her incredible graphs and charts. So you're not going to want to miss the download for this week's interview.

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Bonsoir Juliette! It's great to have you back. I want to start with a question. We're asking everyone which is secular inflation, is it really about to happen? Some people say this is the late 1960s. We're about to have a massive inflation driven by all of the government stimulus and everything that's expected. And frankly, at this point, I really hope you're a deflationist because we've been looking for one.

Juliette: Well, secular questions are difficult. I think I want to emphasize that, you know, we really had a very high uncertainty point. Nonetheless, that's the key question and I will constantly revert to it in my 2021 outlook and beyond. But really, I think a fair answer is that we do not know. So why we don't know. Well, we're talking about unpredictable, nonlinear human behavior. Exacerbated by the high level of macro uncertainty emerging from the 2021 global macro revolution.

A revolution towards a policy mix that is standing on two fiscal legs, two legs, fiscal and monetary. The first one, which is very highly political and therefore volatile, and the other one which basically embodies a new and much more dovish but largely undefined reaction function from the Fed. Also, consider the added risk of pervasive Social Media Group saying, so let's think about it. You've paid people to sit on their butts for a year. Sometimes more than than they were paid when they were working. Will they happily return to work for less pay? Or will the Phillips Curve kick back in forcing CEOs to beat up wages. Recently with my clients, I'm navigating towards entering this key question. I'm trying to stay away from speculating on animal spirits and try to focus on what surprised and what we know for sure.

I think really another important element to consider and that will take me to chart 0 of my chart pack is that to answer this question, you have to also realize that the main risk to reflation is actually inflation and you can see that for yourself on chart 0. The question there is, at what point do higher prices become self limiting by curbing down demand, and that has been stable over the past, basically, like all decades on my chart. In my opinion, there is a non-trivial risk that the US breakevens curve, so the inflation curve continues to flatten and invert in a move that would signal stagflation, and eventually a return to disinflation. And that's obviously, if and when the fiscal first recedes. So just to answer your question at this point, I don't expect one hour inflation. But I keep my mind widely open on the subject as the risk skew on inflation as certainly shifted dramatically over the crisis and certainly for the foreseeable future.

Erik: Well, that brings me to a closely related question Juliette, which is the recent sharp backup in long term bond yields has raised fear among a lot of investors that it could short circuit the economic recovery lead to an equity crash. There's every imaginable, you know, story out there about what this means, what's your take on it?

Juliette: So I think to answer this question and clear as possible way, I would like your listeners to consider the second chart of my chart book, which happens to be chart 1. Yes, markets are calling the feds bluff and refuse to believe that it will, or perhaps that it can fulfill its new FAIT mandate, which is flexible average inflation targeting. Why? Because the new mandate is extremely vague so far. And I stress that this interview is taped before the 17th of March, which is just before the next FOMC. But I don't expect any resolution on this salient point.

So the Fed has refused to quantify the length of time when inflation would be considered for the average, but also what sort of overshoot would they consider acceptable. So far, all we have is a vague promise of a moderate overshoot. This tells us very little and therefore leaves markets to their own interpretation. So as a result, as you can see on chart 1, you can see that the Fed hikes have been priced as early as late 2022 now. Which is a reaction function that is materially more hawkish than officially argued by the Fed.

So looking at the chart, you can see that five year inflation breakevens are now compatible with sustainably achieving the 2% target. On this, I want to add that the Fed targets core PC rather than CPI, on which breakevens are priced. So there is a circa 30 basis point wedge between PC and CPI, which basically explains why breakevens at 2.5% only anticipated tiny overshoot.

But what's more worrying at this point, as far as the feds mandate and credibility are concerned is that the breakevens curve is dangerously flattening and it is actually unprecedentedly inverted, which means that whilst the target could be reached in the medium term. Markets do not currently anticipate that it would be sustainably met in the longer run. So to answer the question of whether higher rates is a problem, we probably need to go through why it would be a problem for equities and eventually for financial conditions, which in turn would become a hurdle to the economic recovery.

Well, a dominant equity sector, especially in the US, is priced on lower real yields. So it's the famous growth sector, and the fear is that it may crash eventually dragging down global indices. As a reminder, growth sectors historically tend to trade like long duration assets. Why? Because they are made of new or pioneer industries, full of promises of exponential earnings growth in the far future. These promises to deliver exponential earnings in the long run is easily revalued through lower long term real yields and collapse term premia. And this basically allows the sector to become positively correlated which bonds which was the main counters lately call monetary policy lever over the past business cycle.

So that's like for 10 years, some of new traders who haven't seen or haven't trained before the global financial crisis would only refer to this market dynamic. As an aside, it was also the main source of disconnect between Wall Street and Main Street, because bad economic news became a positive driver for the bond like growth sector.

Erik: Juliette, having now established that the legitimate concern is a valuation concern for the growth sector are higher yields threatening an overall bear market as a result.

Juliette: So again, for those who were not trading pre-global financial crisis, after which financial repression became the main source of monetary loosening. It's important to reiterate that periods of bear steepening, as happened here today actually tend to coincide historically with stellar earnings growth and equity performance.

This should not be a surprise, the US yield curve tend to best steepen when higher yields are warranted fundamentally. And the market dynamic is one that allows the front end of the curve to move higher without disrupting the positive repricing of the long term cyclical outlook. So that's something you can verify for yourself on chart 2 of my chart book. Bear steepening periods have tended to coincide with periods of equity price acceleration.

Conversely, the yield curve tends to bear flatten when higher yields result from an unwarranted hawkish tilt in the central bank's reaction function. This is what happened in 2017-18 when Powell's FED needed a short term bounce of confidence from the supply side stimulus. So that was like basically Trump's tax cuts with a demand led sustainable cyclical bounce. So it led to two years of bear flattening, which basically culminated in the 2018 Q4 crash, and the feds subsequent 2019 dovish U-turn.

Similarly, such bear flattening dynamic is what burst the tech bubble in 2000. Having cut rates by 75 basis points in 1998. To prevent the LTCM collapse from causing a recession. The Fed started to raise rates from mid 1999 in a bid to tighten financial conditions and counter the speculative tech mania. Reflecting overly tight financial conditions, the US yield curve then started flattening, eventually inverting in February 2000. And triggering a three-year equity bear trend only interrupted for a few months at the end of 2001, beginning of 2002 by bout of bear steeping, which actually allowed an equity bear market rally of almost 25%.

So my message here really is not to look at absolute deal level. That's really not what matters for equity indices or even for the real economy in general. But what we need to look at is how this yield level relates to the outlook. So in other words, restrictive yields will tend to flatten the curve once accommodative yields tend to steepen the curve. So on chart 2, you can observe that the US yield curve has been bear steepening, which highlights the current market belief that higher yields have not turned restrictive, and do not imperil the cyclical outlook.

In fact, given the faster vaccination rollout, and constant over delivering on fiscal stimulus in the US, I would argue that financial conditions have probably become more not less accommodative this year. And the reason is that they are driven by macroeconomic improvement rather than an hawkish tilt in the feds reaction function. So I think the recent yield is very unlikely to trigger an equity bear market, quite the opposite in fact.

Erik: Juliette, your charts are so enticing, I can't help myself. So please forgive me if I seem to be questioning you. But I hear your point. But if I look at chart 2, you can see that the curve bear steepened back in late 2001 yet the equity bear market lasted well into 2002. So is that contradicting your analysis?

Juliette: So Erik, that's a great question. And a point that's been raised by my clients. The reason the 2001's bear steepening did not end the bear market is valuation and basically the existence of an equity bubble. However, including on MacroVoices last year, when I was heavily against consensus, I've consistently argued against the equity bubble narrative. And I will really stick to my guns on this one and refer you to the chart 3 of my chart book.

So if you look at chart 3, which basically measures the developed world cyclical outlook against SPX forward equity risk premium. Again, many of your listeners will ask why using the equity risk premium. So let me go through that quickly again because it's important.

When an investor buys a stock. He is buying the future cash flow potential of a company and the valuation of this cash flow will depend on the real yield of the alternative safe investment, which is naturally US Treasuries. So the equity risk premium allows a sorrow comparison of valuations across business cycles. And that's really the key point here.

On top of this, the earnings yield is also in my opinion as sound way to assess current valuation levels to expected earnings because the ratio accounts for both dividends and retained earnings. Some talking heads argue today that equities are in a bubble just on the basis that their dividend yields are lower than Treasury yields. And I think that's a nonsense.

So of course, the huge caveat is that growth prospects of a company are critical consideration when using earnings yield. Stocks with high growth potential will typically be valued at a much lower earnings yield. So in 1999, what happened amidst the internet revolution, it was certainly an argument to rationalize a negative equity risk premium for both SPX and the NASDAQ. And I think, in retrospect markets got massively carried away and the lack of a spread cushion between the forward earnings yield and the 10 year real yields were a loud warning signal.

Eventually, rising yields real yields burst the bubble and triggered both a bear market and a recession. This allowed valuation to basically become more realistic and realign with fundamentals as you can see on my chart, which is using the DM composite PMI to picture the cyclical outlook in the developed world.

In other words, even accounting for much greater growth environment in the late 90s. Equity markets on aggregate were grossly overvalued, which is not the case today. In fact, I actually argued with my clients recently, that the recent shallow correction actually offered value and remain quite bullish stocks on aggregate, which is basically a stance that I've retained since late March last year.

Erik: Juliette, that gives us a great foundation in the aggregate. But it seems to me like the big story that you hear in the financial media this year is sector rotation. Everybody's talking about cyclicals versus value and value versus growth and so forth. So as we go back to my second question, which was about the backing up in yield, what do you think this means in terms of sector rotation?

Juliette: So another great question. And of course, there are large valuation disparities, as your listeners will see for themselves on the chart 4 of my chart book which pictures euro stocks estimated earnings yield, which is a typically cyclical index. Together with SPX and the NASDAQ, which is a typical growth index.

So for SPX, the forward earnings yield today is just above 5%, above the 10 year real yield, and it was literally negative in 2000. And as you rightly point out, a fairly priced aggregate hides wide disparities between sectors. So the earning yields cushion that you get in the cyclical heavyweights like euro stocks is 90 basis points and you get a cushion which is 70 basis point tighter with the NASDAQ. So in this regard, one should really question whether the ecommerce and technology sectors which are positively correlated to treasuries should really still trade as such a massive deep premium to cyclicals and value sectors.

Let's think about ecommerce and digital services penetration. It basically got bumped in 2020 as stay-at-home orders became prevalent. But if you are not using Amazon or got yourself a Netflix account over the crisis, how likely is it that you will jump into the services over the next 12 months? My really strong belief is that our focus should be on the absolute strength of value and cyclical sectors rather than on the relative weakness in growth sectors. And I think it's really worth considering that growth sectors have greatly matured over the crisis.

So you can actually see on chart 5, that in the UK and the US ecommerce penetration as seen four to five years of growth in 2020. And this really begs the question, will it stick and of course, I hear more and more stories of those thriving in their lives in a more appealing digital virtual world compared to the dull reality of today's lockdowns. I do see my nine year old son getting great satisfaction from the virtual world as the lockdown in London continues literally since December last year.

But personally, I am looking forward to escape virtuality, which probably makes me sound about 150 year old. But going back to markets, the infamous FANMAG sector earnings went from being more than 13% of S&P earnings at the end of 2019 to more than a quarter of S&P earnings at the end of 2020. Those sectors earnings growth, they won't fall out of bed in 2021. They still expected to grow honorable and probably overstretched medium rate of 20%. But that's actually down from 33% growth in 2020. Meanwhile, S&P operating EPS is likely to swing from minus 25 to plus 45 in 2021.

Even more shockingly to younger generations, whilst credit growth is unlikely to revert to its pre-global financial crisis days. Steeper curves means that traditionally boring bang forward earnings, a sector widely believed to be doomed to secular stagnation are now rising faster than forward earnings in the tech sector. And you can see that for yourself on chart 6.

So all in all, my considerations here really lead me to believe that the rational for the large 250 basis point discount for the financial sector to the tech sector is really plummeting. So the change of leadership between growth and value in cyclical sector is not only a yield story. In fact, the differential in future earnings profile is a greatly overlooked driver of a sustainable rotation away from tech towards value and cyclicals outperformance. You can see that for yourself on chart 7.

So just the last chart to try and finish to convince you. So chart 8, I think you can really see and that's really my opinion that the powerful post-COVID reflationary backdrop necessitates a continued rewriting of financials versus the formerly hot FANMAG sector. And there is a potential just for convergence between earnings yield, there's a potential for a further 40% price rotation. So it's really an underlying trend that has potential and as really just started.

Look my message here is that is that the global equity market is potentially standing on steadier, not shakier ground, which means that S&P 500 equity risk premium is actually likely to fall going forward. Eventually, offsetting the effect of higher real yields on equity prices. And this is something I show on chart 9, and which also justifies selling VIX spikes in structural positioning.

Erik: Juliette, you never cease to amaze me with your graphs and charts. I count five amazing charts on that one question about sector rotation. Let me hit you with another question that I've been asking almost all of our feature interview guests. Which is, it sounds like you think that there's reason to expect higher yields or that higher yields are warranted. If that's the case, how far can they let them go? You know, a narrative that you'll hear is, the US government cannot afford to allow the long end of the curve to go very far because they wouldn't be able to afford their debt service if it went beyond a certain level. Is that true? Is there a level that it can't go beyond? And what is that level? How far can yields go before they become restrictive?

Juliette: So I think this the $3 trillion question, which as recently argued in a really interesting article from the economist, which is titled, "The World's Consumers are Sitting on a

Pile of Cash, but Will They Spend it?". So I think this is what will ultimately drive the equilibrium real yield.

As in my answer to your first question on whether we risk secular inflation, I want to really emphasize the high uncertainty, but fundamental change in this skew around future inflation outcomes. And as a result, I really try and focus on what we do know, and extrapolate from there in terms of finding out what is the most likely pass in terms of yields and real yields and inflation?

We and I should say, at least JDI research clients and your regular listeners know that financial repression, and what I mean by financial repression is negative interest rates and depressed term premia. That basically led us to a much worse equilibrium over the last decade. Firstly, by constraining lending due to desperately tight bank margins. And if we're looking at Europe, especially capital flows there are still relying heavily on banks. So it's a major consideration. And you can see that for yourself on chart 10. There is absolutely no question in my mind that banks are more likely to lend when it's profitable to do so and that consumers are much more likely to borrow when they see a risk that rates may be moving higher, rather than the opposite.

Secondly, we've achieved an inferior macroeconomic equilibrium with financial repressions by incentivizing savings and basically constraining final demand in expectations of lower future earnings. So in other words, you have to save a lot more towards retirement. If you expect that you will get no returns on your savings. And you can see that very clearly on chart 11. And that's really against all central bank's common economic sense. But you can see very clearly that low real interest rates have not been an are not stimulative. But hopefully, we are getting out of that pervasive depressionary cycle.

And obviously, a third thing. And probably equally important, is the move to greater quote on quote, socialism in the US. So whilst in Europe and UK, the poorest were hardest hit financially by lockdowns, the same is not true in the US. According to check accounts data published by JP Morgan Institute. That's something you can see for yourself on chart 12. You can see that the poorest check accounts have increased by like 50% more than the wealthiest consumers. And I think it's a safe bet to say that Biden's administration will address inequalities much more systematically in the future, which will unleash untapped pockets of final demand, which will fuel a real recovery. Obviously, the poorest are more likely to spend than the wealthiest.

So in sum, I think that should really take us to like chart 13 of my chart book. And you can see that these three considerations that you know, we sort of like know for sure really justify markets pricing of a sustainable, cyclical recovery. And that's actually what is priced in real yields by the markets. And we're still rising there and still in the process of repricing the cyclical recovery rather than in the process of ending this recovery.

So assuming a persistent cyclical recovery, which is my belief. I think we can observe from chart 14, that the Fed front end repricing is in fact massively lagging the spectacular improvement in the cyclical outlook, which is measured by the cyclical sectors outperformance versus

defensive. There's another chart that I really like and which I updated today, which is global zoo, which we calculate internally. And you can see exactly the same thing over the past like four decades. It was basically directly leading FED repricing, and now we're basically making new highs with the Fed hikes hardly being reprices at all. So all in all, my strong belief is that the front end rates remain highly accommodative, even after bringing forward the expected timing of future policy rate increases.

Erik: Juliette, that's a great point. So I want to ask you, what do you think the Fed should do at this point?

Juliette: I really believe that the Fed would be completely wrong to deviate from its sort of like "laissez faire" attitude to a virtuous fundamental repricing and basically from its hands off approach to the ongoing bear steepening. So what I expect Powell will stick to, you know, tomorrow and the foreseeable future is a party line of infinite patience, but otherwise, he will try to refrain from controlling yields. If and when markets start short circuiting the recovery by front running the upcoming economic recovery. The most likely answer will be a clarification of the feds forward guidance with a calendar guidance rather than the current obscure current reaction function. But we are like nowhere close to YCC. Given how positive, this repricing has been.

Erik: Juliette, may I ask you to now give us some concrete perspective on what you're actually advising your clients to do with all of this macro backdrop that we've discussed?

Juliette: Well, the truth is that all the considerations we just discussed, leave us with a continuation of the sleekest microeconomic cycle experience I've seen in in my career. So first, we priced reflation on the back of much lower real yields, and we valued growth sectors and generally all liquidity driven sectors and I'm talking Gold, Bitcoin, metals, real estates, and emerging markets, of course, and that was the first part of the post-COVID repricing.

Then cyclicals earnings started to recover with less need for financial repression. And consequently, long term real yields started to rise as they tend to mean revert to around an economy's potential. And that's really the point where I argued that the liquidity ship had sailed and recommended a strategic reset about last month. And in this move, there is still 50 basis point to go in my opinion. In a motion that will take 10 year nominals well above 2% and 10 year real yields back to zero at a minimum. And we are currently around minus 70 basis points. And that will basically cap long term breakevens. So in other words, I've moved this year from recommending that clients pay breakevens to recommending betting on higher real yields, which is now likely to lead nominal rates higher and that's really a natural continuation of a cyclically grounded recovery.

Erik: Juliette, I know you caught a lot of our listeners attention with your comment about real yields increasing from minus 70 bps to zero. That seems to be or I should say that the trend in increasing real yields in the opinion of a lot of analysts is the reason we've seen weakness in

the gold market. So I wonder if that means more weakness. So let's broaden that to both gold and the dollar. Tell us a little bit more about what this change in real yields is going to mean in terms of both of those things, the dollar index as well as gold?

Juliette: Yep, sure. I mean, in fact, gold this year, I was like, sort of like trip me over. And I'll tell you why. Because I think it will answer your question. Basically, I came this year with a very strong view that the US real yield curve would continue to steepen. And that's worked very well, but the challenge is, what does it mean for all assets.

So what I really did not expect to happen as quickly as it has. And this really, I think, will be the typical Q1 catch that might be continuing into the rest of the year, was for the real yield bull steepening to turn so fast into a real bear steepening. So what we had last year was the real yield curve, overall steepening but with a weight bound, and we are now basically, pivoting higher. And what this move is doing and basically spells the beginning of the end of financial repression, and that of a micro cycle which relies purely on excess liquidity, and fast and easy financial asset appreciation.

And that's really why I recommended last months to and that was premature in my initial framework, to take profit in short dollar and also take profit in long EEM recommendation. And that also led me to take a loss in the long gold recommendation I had. Going forward with the Fed likely to follow rather than lead market pricing on yields, there is really no reason to believe that US financial conditions will become too tight for the US or for the rest of the world, indeed.

So this leaves us as we discussed in the earlier question, with still a positive global recessionary stance, which is a clear signal for the greenback. A clear bearish signal for the greenback, and it would be for gold as well. And that's something you can see on chart 15. Also, front end real yields differential still indicates a continuation of the dollar downward trend, as shown on chart 16. But really, this is where it gets more confusing, and why I'm actually no longer recommending either long gold or short dollar. Rather than over promising and under delivering, the opposite has happened. And Biden has basically outdone, the wildest market expectations in terms of fiscal stimuli. And that's really allowed markets to price a much faster return to trend growth in the US.

And as a result, whilst I initially expected long end real yields to just grind higher as the front end collapse, which was justifying long gold and short dollar, the new dynamic, which I think will be perseverant is one of the long end upward trend. So that's where we're talking from like going from minus 70 to zero, which is actually resulting from lower front end real yields. That's what I call basically the higher, long end real yields are now leaking into the front end. And this move is likely to continue accelerate upon economic reopening and support the dollar. And this is a dynamic I pictured on chart 17.

It's especially true because the Fed now appears more likely to accommodate higher term premia than its DM counterparts. We've seen recently the RBA, the ECB, really pushing back on a strongly on higher term premium. I think eventually the ECB the RBA and even the BoJ which

is now talking about allowing more of a free plot of the tenure as part of its review. I think they will all come to the view I expressed in this interview and in the report I published that steeper curves are absolutely conducive to much looser financial conditions. And that will eventually allow the dollar downtrend to reassert itself. But I think we're not there yet.

So clearly, I'm a bit ambivalent about the dollar. And I've given up on gold after like a fantastic 2020. Really, it was central to be long gold in my recommendations. And now because we are looking at higher yields being driven more than by real yields than by breakevens. I think gold will lose an anchor. So I'm really going to be looking for opportunities to trade extremes in the dollar with a view to eventually re-embracing our bearish outlook. But for now, it's really on ice and not warranted.

Erik: Truly, I want to go a little bit further on gold if we can, I couldn't agree with you more that it feels to me like gold has further to go to the downside. And the reason is increasing real 10 year yields. It feels to me like this is a gift and opportunity. And of course, it's always hard to time exactly where market bottoms are. But it feels to me like we're coming into a buying zone where there's going to be a long term opportunity.

And that at least in my thinking is based entirely on an expectation that inflation is coming. And I think it's coming in a big way. And when that inflation is actually registered, we're going to realize that real yields, even with nominal yields, backing up, real yields really are returning to negatives. And at that point, I think gold really takes off. I'm just curious, since a lot of our listeners have been following the gold market very closely. Would you agree or disagree with that view? And why?

Juliette: Yeah, so I think I completely agree with the first half of your question, you're thinking that we haven't seen the bottom, we haven't seen enough of a correction in gold to re-enter here. I did consider recommending to sell gold. But when I've got the strong view, I tried to go to the root of my macro thinking. And my macro thinking really is that real yields will go up. I'll tell you why I recommended short tips rather than anything else is that I feel the biggest risk to my reflation or review at the moment is indeed inflation. And inflation, which like an oil shock would basically be shocking demand negatively, in which case, I think the inflation curve would be like collapsing, basically inverting and collapsing, which basically means that real yields would be shooting up.

So I quite like the idea given up in recommending a strong beta to risk assets to have this sort of like bubble, where I think real yields go up in reflationary scenario, but it could also be like shocked higher in a deflationary scenario brought about by higher inflation. So I would Yeah, I would agree with your scenario on gold. And it's really a matter of probably looking up the shape of the curve, really the shape of the breakevens curve and the shape of the real yield curve.

Erik: Juliette, I can't thank you enough for another terrific interview. But before I let you go, please tell our listeners a little bit more about what you do at JDI research. And I know in the

past, we've managed to wrestle a special offer for MacroVoices listeners on a trial to your service. Is that still a possibility?

Juliette: So what I do at JDI Research first – So I advise institutional clients, but I also have like, a small pocket of retail or high net worth investors that I've been following my views and benefited from my recommendations over the past five years. And, you know, generally happy clients. What I do over every MacroVoices interview, which only happens basically twice a year is I try and offer those MacroVoices listeners a small discount on a one-year subscription. And that's something that I will be happy again to extend to your listeners. And I really emphasize the fact that I only do it twice a year. And only over MacroVoices interviews.

Erik: Well Juliette, I look forward to getting you back in a few months for another update. Patrick Ceresna and I will be back right after this message from our sponsor.