Jeff Snider: Why Deflation Is The Story, Not Inflation

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Erik: Joining me now is our good friend Jeffrey Snider, Chief Investment Officer for Alhambra Investments and famous for his slide decks. Listeners, you'll find the download link for Jeff's slide deck associated with today's interview in your research roundup email. Now, if you don't have a research roundup email, that means you're not yet registered at macrovoices.com, just go to our homepage at macrovoices.com, click the red button that says looking for the downloads, just above Jeff's picture and just below the green Donate button.

Jeff, the big conversation we're having with all of our feature interview guests is inflation or deflation. And frankly, we've gotten to the point where it's hard to find any deflationists left. We had Steven Van Meter on a couple of weeks ago as you know. We've got you, we've got David Rosenberg scheduled. We're trying to get Lacey Hunt. I think that's all the deflationists that there are at this point. Now I saw that the finance secretary of the Philippines was rushing a $1 bond sale because he wanted to get it done before interest rates skyrocket. That's exactly what he actually said.

So it seems like there's nobody left almost who doesn't think that both inflation and bond rates are headed higher. Richard Nixon once said, we're all Keynesian now butchering something that Milton Friedman had written a few years earlier. But in 2021, it really does seem like almost all of the macro gurus that we know, that we invite on macro voices have turned into what Louie Vincent Gave called inflationistas. Maybe you and Steven Van Meter, and Brent Johnson and, I guess David Rosenberg are the holdouts. But it's getting to be a pretty darn lonely place for you remaining deflationists.

Jeff: Yeah, you know, I think when you think about it, Erik that history has repeatedly warned against some of the things that we're kind of seeing now, these excesses. And I think there's some intuitive sense behind why everybody's starting to think about inflation and only inflation. As you know, very well, Erik, I personally don't equate it to what governments are in central banks are doing to that at all. I don't think I'm alone in that view, though. And I think that's where I really object.

But you're right, in one sense. In the media, anyway, inflation seems it's written about as a foregone conclusion. The mainstream view is always the same that, you know, determined governments can and will create inflationary circumstances if they really want to. And even though governments have for, you know, more than a decade now really wanted some inflation, they haven't been able to get it. So I think that's what people are thinking is different now that governments have gone to a whole other level. And so it's just a matter of time.

Erik: Okay, Jeff. So, the question then is this time different? Of course, that's a cliche phrase. but look, you know, this is a secular thing. You go from deflation to inflation, there's got to be inflation someday, question is when. Every possible means has been ratcheted up to intentionally create inflation. And to me, I think the big difference now is, although it's true, and I will be the first to admit that a lot of people, myself included, misunderstood quantitative easing in the beginning. We thought it was going to be inflationary, then. Well, it wasn't because it was creating bank reserve, not pumping money into the real economy.

The thing is, what they're talking about this time around Jeff is different. They're talking about pumping money into the real economy through things like universal basic income, and other transfer payments and various other things that they want to do with infrastructure spending, and so forth. It all sounds to me like a completely apples to oranges or apples to bananas comparison, when you compare this to the first rounds of quantitative easing, which admittedly, were not inflationary, as many of us thought they would be.

Jeff: Yeah, exactly. And I think, you know when you see some of these things, for the first time, universal basic income, for example. Or MMT, some of the edges of MMT. You know, it sounds like okay, this is something new. And I guess, you know, these are intended to move around the banking system to not do quantitative easing, to put money into the real economy. But you have to realize that even MMT is really just Neo-Keynesian with the usual traditional boundaries removed, which is what I think everyone is up in arms about that. Okay, now, we're going into a whole different thing.

But here's the thing. We all know that officials are moving in that direction and have at least expanded the boundaries of deficits and QE bond buying heading that way. Yet, the inflation narrative is a hard sell anywhere outside of the mainstream media or maybe the stock market. The financial press is certainly sold on it and the stories they write are practically uniform and declaring that this is absolutely going to happen. Inflation is going to happen because Uncle Sam and Jay Powell have done an extraordinary job to the point that the risks are now that they're going to do too much.

But this is not the view of the marketplace, which means that there is far less agreement than it may be otherwise seems. Even today, right now, the inflationists are the ones who are holding out because the entire bond market globally, remains firmly. And I mean firmly in the nothing has changed camp. Despite trillions upon trillions and deficits and QEs worldwide. You know, universal basic income and MMT light that is now infecting official discussions and political considerations. There's actually very little so far as inflation expectation, despite every one of those things.

Erik: Well hang on a second Jeff, because it sounds like you're saying that the whole inflation idea was just made up by the media is their creation. Now, I know that I personally have been saying for more than a decade, I don't know when the inflation starts. But I do know that's where you get to an endgame situation, because you've got a deflationary backdrop, you can solve almost any problem by printing money off the printing press. But when you have an inflationary backdrop, now all of a sudden that money printing becomes even more inflationary, and you've got a self exacerbating problem. So I think a lot of us, myself included, have known for years that someday there was going to be a reckoning with inflation, it had to come someday. The media hasn't persuaded me that this is happening now. What's persuaded me that it's happening now is all of the politicians I see running around looking for new ways to print and spend money.

Jeff: Yeah, and I think the question you're asking is, is this today. Is today the day that we've changed from inflation to deflation. And here, look, we have the biggest, deepest, and most sophisticated markets in human history, all across the world. And each of them agree on this point. There's been a small but significant improvement in expectations over the past few months. But nothing, absolutely nothing more than that. And even that has been underwhelming, distinctly unimpressive.

Furthermore, we've seen this very argument take shape, time and time again, the last time just a couple of years ago. But that's not how this narrative and it's really a narrative. And we're going to start on the slide deck on slide three here. That's not how this is, you know, the narrative is being presented in the actual marketplace. Going back to early January, the global bond market has indeed sold off. But now it's being pronounced to some kind of historic route, which purportedly has unsettled every last deflationist on the planet. As you said at the introduction, Erik, you know, how many holdouts are there left? So you know, and that's intentional to create the notion that this is some big change in the condition, the underlying condition in the more likely the outlook. As you said, is the market starting to get the sense that politicians are getting the will and the desire to go beyond any kind of traditional boundaries.

You know, that was really the point of calling it a historic bond sell-off and playing up the rise in interest rates, particularly. By claiming that this is something different, it already implies that there's more meaning to this one. Not only is the bond market selling off, this must be the sell-off that we've been hearing about for a long time. That this is the time when deflation has ended and the bond market is getting ready for the looming inflationary regime. And the reason is always again, that governments and central banks have done such a good job, that they've completely changed around the risk, which now at least according to this conventional view, have swung all the way around to become firmly inflationary.

Erik: Okay, Jeff, at the very least, you stipulate yourself on the last line here on slide three. You're saying governments want inflation and they're willing to do anything to get it. So you acknowledge that. Now, I would say that governments don't really understand what they're doing. And they're probably going to overshoot and create, essentially start a fire they won't be able to put out. That's the way inflation tends to happen. As the government gets too complacent, gets too carried away. Eventually, you get to the point where by the time they figure out that the inflation is really burning, it's too late to put the fire out. You're saying it's not happening? Wait a minute, help me out here. Why is it not happening?

Jeff: Yeah, and I understand that view because it's almost like stretching a rubber band, right. You know, failure after failure QE after QE didn't work and so they keep pushing the boundary, they keep pushing the boundary, they keep stretching the rubber band, and eventually the rubber band fails and the whole system blows apart and you know, I get that. There isn't any doubt that governments have expanded what they're doing because you know, to me it's based on, predicated on past failures. The fact that we're still stuck in a disinflationary route, what is it now almost 14 years after it began. You know, and there's any number of statistics or data points which demonstrate the fact that these are not normal times. That we're going through some A historic types of changes.

But whether a period of monetary or seemingly monetary when you look at things like M2, for example. The M2 monetary statistic, which is on slide four. That has been rising at historic rates, about 25% annual for about a year already, and related to it through QE bond buying, the feds level of bank reserves has exploded upwards of just about 4 trillion, which is by far our record.

And then on slide five, you can see, you know, the combination of quantitative easing, plus the latest round of Uncle Sam's helicopter in recent months. You know, the treasuries TGA balances being drawn down with these government payments into the real economy, which is the latest round of quote-on-quote stimulus going out by the hundreds of billions. This then comes to the rest, it goes into the commercial banking system as this rising systemic bank reserves. It's a flood of at least central bank accounting to the tune of nearly three quarters of a trillion in bank reserves over just the past nine weeks and that represents the government moving money into the real economy through these these government treasury payments and stimulus.

But at the same time, or at least much the same time. Fixed Income markets globally have definitely pushed over into some into the reflationary trade. That's where you see selling and bonds, rates rising, etc. Because it really might seem like everything, and I mean, everything has turned positive, whether it's vaccines, whether it's this flood of bank reserves, it's government payments, you know, we had the huge payroll report in the US for the month of March 2021. We've had record high PMIs, you know, especially their price components of the PMIs. You know, there's reasons behind the sell-off in bond markets and the rise in interest rates. I think the problem is, or the issue is, is interpreting these market signals, putting them into relevant context and then understanding how the vast majority of market participants must be seeing all of these same things.

Erik: Jeff, you and I have talked about the Eurodollar system quite a bit over the years. But I want to talk about Eurodollar futures, specifically, because you've got them on this slide. And I think this is an area where we have a lot of confusion, as we talked about the Eurodollar system, but not as much about what the Eurodollar chart is actually telling you. As you see Eurodollars trading at a certain level, what signal is that giving you? Or what does it tell you that policymakers are trying to achieve?

So I'm looking at the December 22' contract on your chart, slide six, and a contract price of somewhere around $99.50. And that looks like this particular contract is pricing, maybe one rate hike before the end of next year. And then these other contracts further out, have priced in quite a few more. Explain this slide in terms of how investors listening can interpret this data, what information do they glean by looking at this graph?

Jeff: I think that's commonly what people say when they talk about Eurodollar futures. But it's not quite what the market is actually indicating. Futures contracts, especially those further out into the future are essentially embedded probability distributions. So at a price of $99.50, which is the December 22' contract, there's an implicit probability distribution that says maybe a rate hike, maybe more than one rate hike, but most likely not any, it's just at $99.50, the probability isn't zero, like it had been priced before January.

So in the grand scheme of things, that's a very minor improvement in Outlook, and it doesn't say the Fed's gonna raise rates by 25 basis points before the end of next year. The market is saying there's still a good chance that LIBOR doesn't move at all by the end of next year. But now there's maybe a small chance that it could, within incrementally increasing opportunity, the further you go out in the future, the further you go down the Eurodollar futures curve into the far more distant contracts.

Erik: How much of that is just Powell and the Fed? If LIBOR is usually correlated pretty closely with the Fed Funds Market and the Effective Fed Funds Rate. Isn't that just an expectation or an indication of coming monetary policy? Powell and other FOMC members have said repeatedly that they're not in any hurry to raise rates, and they're anticipating sticking to the zero lower bound, not just this month or this quarter, but for years, and they do have a tendency to be wrong a lot, especially where inflation has been concerned, quite frankly.

Jeff: Yeah, but here's the thing, the Eurodollar futures market has led the Fed, it doesn't follow monetary policy. This market knows what Jay Powell is going to do before he knows what he's going to do and that was absolutely the case the last time we went through this, Erik. You and I talked about this just a few years ago, quite a lot back in 2018. Well, Powell back then was usually hawkish, think back to the middle of 2018. You know, claiming his expectations were for an accelerated rate hike schedule well into 2019 and beyond, because he said inflationary pressures at that time were building you know, the unemployment rate, full employment, all that stuff.

But here it was the Eurodollar futures contract all the way back in June of 18', which called them on it. When the curve inverted in that month, that was the market indicating that there was a growing and serious probability that the Fed would end up cutting rates not hiking, as it was doing at the time, as it was expecting to continue to do well up beyond 2018. So you know, it was the Eurodollar futures that ended up being absolutely correct. Powell followed the market, rather than the market following policy projections, you know, the dot plots and all that other stuff.

So in 2021, if these contracts are priced where the market believes there's a significant chance of continued zero, or near zero money market rates. That's because the market is pricing likely outcomes that will force Jay Powell over time to acknowledge them, regardless of what he thinks today and it wasn't just 2018 when Eurodollar futures proved themselves obviously. Back, you know, go back to 2006, the curve, the Eurodollar futures curve inverted at that time, which was suggestive that things were going wrong many months before, you know, Bernanke confidently told Congress that subprime was contained.

Erik: Well, it was also true in 2013 wasn’t it? The taper tantrum was really a reflation trend, but one that didn't last very long. Bernanke's Fed was turning optimistic, and the market turned with him. But then even before the end of that year, it turned back against him again.

Jeff: Yeah, and that became the standard view of how the improving economy or a rapidly improving economy at least according to the unemployment rate. That's how it was supposed to allow the Fed to taper first QE3 and QE4 before then kicking off rate hikes sometime following the end of those programs. You know, that was the trigger for the global bond sell-off, including Eurodollar futures from May 2013 onward. But it hadn't been a negative reaction to fewer Fed purchases.

It was the probability distribution I was just talking and Eurodollar futures particularly that was shifting more optimistically on inflation and growth, which are the factors underlying real recovery, their force gets set into, you know, three months LIBOR and things like that. So you know, translated into all the potential future path for three month LIBOR. Selling in Eurodollar futures had meant a higher probability of Bernanke's view paying off. So if you go to slide seven, you can clearly see this in the way the Eurodollar futures curve shifted between May and September 2013.

And then on slide eight, the curve in early May was pretty low and flat, which is, you know, not a very good, not a very optimistic type of curve. It's not the kind of thing that you associate with inflationary recovery. Instead, one that is perfectly consistent with the conditions of that time, which were not very good. You know, expectations at low flat curve were basically expectations for continuing disinflation, and the lack of robust economic growth. But once Bernanke said the word "taper" early in May 2013, which was projecting unusual confidence. Remember, Fed Chairman usually try not to say very much. That's when the Eurodollar futures curve sold off along with the US Treasury market and MBS, and all sorts of fixed income. Which is to say that the Eurodollar futures curve steepened quite a lot, as you can see on slide nine.

What that meant was that the market was incorporating these more favorable probabilities of the future, particularly further down the road beyond the near and intermediate terms. The farther over the horizon, you look, obviously, there's greater, there's higher uncertainty. So on slide 10 and 11, Bernanke's sudden confidence jump started some optimism about the longer run. At least until September of 2013. Now, this wasn't the market rushing to embrace the unemployment rate, we have to keep in mind that it was a relative shift in future expectations that were more favorable than the uniformly awful expectations that were priced in the May 2013 curve. In other words, you know, from a high probability of really awful future to one that was perhaps a little less than a little less likely awful.

Erik:
Well Jeff, what that meant looking down the road half a decade or more. At least if we go by the Eurodollar futures market, and its forward curve was the potential range for three month LIBOR that shifted to become somewhat of a higher range than it was before. I think I've heard you say before, Jeff, that this is how you define reflation and how that is different from recovery.

Jeff: Yeah, when the market, or even if the market shifts from a small probability of something like more normal LIBOR half a decade into the future to something that's more of a better probability for it. That's when you know, recovery has a real chance. It just hasn't happened yet and it's not even, it's never even been close.

So if you go to slide 12, you can see why the probabilities for recovery always price very low. Time and time again, it just hasn't panned out, it always fails, it's always these false dawns. We keep hearing about promises for inflation, governments do more and more and more QE, more fiscal spending, whatever it is. And as it as it always turns out, you know, as it would eventually turn out, the May 2013 Eurodollar futures curve is actually much much closer to where three months LIBOR ended up being all the way in the distant future. Not the more optimistic reflationary September 2013 curve.

So what the 2013, reflationary shift or sell-off in global bonds that included Eurodollar futures, what they had been was nothing more than a temporary, I mean really temporary, slight improvement and outlook before too long by the end of 2013 in Eurodollar futures as well as in the US Treasury market. The entire global bond market was already repricing probabilities back closer to what the curve had indicated earlier in May. At the same time though, Bernanke's Fed was growing even more confident, even more optimistic recall that they didn't. They actually did taper QE in December of 2013. But then watched helplessly as global rates fell, not rose and Eurodollar futures prices kept going higher, not lower.

And as Bernanke handed off to Janet Yellen, you know Yellen's Fed never did get around to those aggressive rate hikes that seemed at least somewhat plausible during that inappropriately named "Taper Tantrum sell-off". So the higher probabilities for potential recovery, which were never good even in the reflationary curve of September 2013. Those slowly painfully disappeared throughout 2014 as the Eurodollar curve, like the yield curve, shriveled, shrank, and compressed all over again.

Erik: Let's put this all into the current context, because what you're saying and what these markets appear to be doing is obviously similar. Using what you just said about the 2013 reflationary episode. What can you tell us about the market structure in 2021, and even beyond this year.

Jeff: We'll start on slide 13 and that's where the curves had been last year at their worst, their lowest, their flattest, their most pessimistic point, which was on August 4th. So over the past eight months, which is now 2/3s of a year, both treasuries and Eurodollar futures have been selling off, that's reflation. And as we looked at that before, it picked up significantly earlier this year in January, and that's on slide 14.

But viewing these again, as curves, visually, you get the same impression as 2013. It starts out really flat on slide 15, which is a curve that indicates very little chance of substantially higher three months LIBOR rates in the futur and just overwhelming probabilities of really awful outcomes, which would leave three months LIBOR never getting that much higher than zero for, you know, four or five years long, long way until the future. You know, by the middle of the current decade. You know, that's probably the best way to describe last year.

But after the latest acceleration reflation between January and March of this year. The curve has steepened significantly as you can see on slide 16. But what does that actually mean? Is this the historic sell-off that everybody's describing or has been describing every certainly every mainstream financial news outlet? Is this the market becoming more and more certain that inflation and even runaway inflation is a growing likelihood that governments have finally gone too far, that they've stretched the inflationary rubber band too far and it's about to snap? Well, all you have to do is compare the changes in the recent curve to those from 2013 as I did on slide 17.

Erik: This is what you'd meant earlier when you said the current reflationary sell-off is underwhelming, or what was the other word you used?

Jeff: I believe I said it was unimpressive.

Erik: I think you said it was distinctly unimpressive.

Jeff: Yeah and I think it's because it really is. I mean, you look at these charts on slide 17. I mean the current Eurodollar futures curve, the one that's supposedly projecting all these quick developing rate hikes as is commonly described. It's pretty much the same shape and nominal parameters as it had been in May 2013. And the May 2013 curve was essentially back then. That was the markets worst case scenarios and probabilities.

So if you go to slide 18 and 19 back to what those curves were projecting firearms in the future, half a decade or so ahead. You know, the reflation curve was somewhat closer to normal, the one from September 2013, meaning higher short-term interest rates, while the May 2013 curve, the one remember that ended up coming close, really close to what actually happened in the longer run future.

That was for basically the same continued lack of inflation and growth, despite Ben Bernanke and then Janet Yellen's expectations and assurances that these things really were picking up. And so if we put the current curves into that context, you know, oh, boy, I mean, look at slide 20. The best case today, the reflation case right now is for a group of probability distributions that end up looking like what had been the worst case eight years ago.

Again, the distributions that actually came closer to the truth. So let me say this again, even after the so called historic reflationary sell-off. The Eurodollar futures curve is projecting an intermediate and longer run future. That's about the same as the awful projections were back at that time. Our current best case for growth and inflation, therefore higher rates in the futures is right now after this reflationary sell-off, about the same as past worst cases.

Erik: And this market is obviously pricing in and discounting all the factors you mentioned at the start. What seems like a bunch of good news and the vaccines and economic data improving as well as the ridiculous excesses of the Fed or ECB, along with the US government and its counterparties all around the world.

Jeff: Yeah, all those things are in there and the market is priced as if in all likelihood, they won't make much difference at all, to the point that reflation in 2021 has been so thoroughly underwhelming given how everything and I mean everything is supposed to be going the right way now.

Erik: Jeff, why is that? How can this really important market discount all those different things?

Jeff: Well Erik, you know, for one thing, the market like anyone who's who's been paying attention has seen this reflationary trade time and time and time again. This would actually be the fourth or fifth, depending on how you count. And you go to slides 21 or 22 here, you know, contrary to how it's being written up, reflationary sell-offs, like this are nothing new. There's nothing historic about what's going on right now.

And what that means so far as the current curves indicate is that even though the numbers are bigger, you know, government interventions, the idea of the pushing the boundaries, all that stuff. The bond market remains completely unimpressed by them, because in the end, they really are all the same things. I know they're being described, and they look like something brand new, something very different.

But the truth is, they're just bigger numbers and bigger experimentation, even MMT. Like I've said before, it's just Neo-Keynesianism with a little bit of a different spin to it. And so contrary to popular belief, there's loads, there's gobs of history and scholarships on these things, which all come down as well as practical experience. And all of these things come down on the same side as Eurodollar futures, no inflation. In fact, there's higher chances of continued disinflation and the occasional outright deflation, just as we've seen since 2007. And that's why in slide 23 you see how the market over these past 14 years keep pricing is best case reflationary curves, lower and lower and lower over time.

Occasionally, it might look like there's a chance things could end up going the right way. But the market over time, only discounts that probability more and more even at its reflationary peaks or reflationary best.

Erik: Okay, so am I to take your statements to mean that the long run flattening out of the Eurodollar futures curve is basically the majority case for the Eurodollar futures market becoming more certain about the financial system. And I guess the economy never being able to escape from its deflationary rut. Is that your argument?

Jeff: That's it, I think, you know, it's not just my… it's the market, the market is saying...

Erik: Never being able to escape...

Jeff: Right, it's the market...

Erik: Never is a long time!

Jeff: Well, never is, yeah, never is probably too strong a word but at least in the foreseeable future, which again, in these Eurodollar futures curve extends well out over the visible horizon. It's the market saying despite everything that's going on right now, it is priced for an exceedingly small chance of even 2% LIBOR, or 2% three months LIBOR by the middle of the current decade. That somehow a smaller chance than the middle of the last decade which as everyone knows did not turn out to be an inflationary outbursts that had been uniformly promised by central bankers, economists, and the media and so forth.

So you can see by these curves just how small the probabilities are reflected in the shriveling and shrinking of them. So even at their supposedly best, like right now. It gets smaller and smaller and smaller over time. Each and every time this inflation debate shows up, each and every time the government pushes the boundaries or says it's pushing the boundaries, nothing changes.

The market becomes instead, more and more resolute, as you can see on slide 24, and 25. And you can see how it is especially when you compare what's supposed to be, you know, this inflationary monster in 2021 against not just these post-2008 reflation curves, but even more so against the backdrop of the pre crisis curves. There isn't even a touch of inflation right now, even after the so-called historic sell-off.

Erik: To be fair, the term historic has been used only in conjunction with the sell-off in US Treasuries. Treasury prices at the long end of the yield curve have fallen by a sizable chunk.

Jeff: Yeah, absolutely. That's true. But it's really all the same thing. You know, it's the ubiquitous quote-on-quote bond market, which includes all these related pieces like Eurodollar futures. You know, They are no islands in fixed income. So while long end US Treasuries have sold off in price, and I suppose that historic sell-off when you measured only by calendar quarters. That still hasn't raised rates all that much in the exact same way and for the exact same reasons that Eurodollar futures haven't given up relatively that much ground either.

If you go to slide 26, 27, and 28. The history of the last 14 years in the US Treasury market is remarkably similar to the trends in Eurodollar futures that we just went through. You see, you know, repeated reflationary sell-offs one every few years. But these get weaker and less impressive by the cycle. And this is the US Treasury yield curve pricing the same sets of probabilities that are getting priced into Eurodollar futures curves.

That's why the trend in the yield curve over time as you see in slide 30, and 31, it's the same as in Eurodollar futures. That curve like the other one, it just shrivels and flattens down almost to nothing, which is each of them pricing in such low probabilities for inflation and growth. And in Eurodollar futures that's in the form of future three month LIBOR. Where in the US Treasury yield curve, itt comes at, you know, the Treasury curve comes at it more directly from inflation expectations and growth projections.

Erik: Jeff, haven't inflation expectations in the TIPS market jumped higher though? I mean, maybe Eurodollar futures are long end Treasury yields aren't yet pricing in inflation. But TIPS inflation breakevens sure seem to be, don't they?

Jeff: Yeah, in the short run, that's absolutely true. The 5-year TIPS breakeven for example is the highest that has been since 2008. But that doesn't even mean as much as it sounds as much as it's been made of. And the key reason why is that inflation expectations further out in the curve into the longer term. They're not nearly so impressive sounding.

The 10-year breakeven, for example, maybe as high as it's been since 2013. But we just went through how an impressive expectations in 2013 had been. So being compared to 2013 isn't as much as it sounds. It's gotten to the point that since January, you know, this January reflation Bonanza that kicked off these TIPS inflation expectations, the tips breakevens have become inverted, so to speak.

Erik: What do you mean by inverted?

Jeff: Well if you go to slide 32, normally short term inflation expectations are those further out on the curve, the longer term expectations. We would expect to find that the five year inflation breakeven would be below the 10 year. Since January, however, it's been the other way around for the first time since 2006. The five year TIPS breakeven is now considerably more than the

10 year, which has been a record amount of inversion since 2021. And that's the TIPS markets way of pricing the curves of both Eurodollar futures in nominal treasuries. It's its own way of saying that, yes, there may be some additions to the CPI in the short run, whether that's commodity prices working their way through or even the near term impacts of all that monumental government stuff. But the market does not believe it will last. That whatever it's going to do, if anything much at all, in terms of economy inflation, there very isn't likely any lingering impact.

And you can see on slide 33, and 34 how this could be when you take into account the Eurodollar futures and yield curves and what they say about longer term prospects, which is nothing good. And then match those up with long run inflation expectations, which have trended the same way over time as those curves. The 5-year/5-year forward inflation rate, which is derived in part from that allegedly scorching hot five year TIPS breakeven. This hasn't changed much at all over the past year, like Eurodollar futures or nominal treasuries. This long run measure of inflation expectations, it has improved from 2020s low. But again, that's such a low bar, it hasn't actually moved all that much the same as each of those curves. And it remains substantial, even visibly depressed when compared to 2013 and before.

Again, another consistent view that the long run decade of the 2020s is somehow going to be even worse than the 2000s 10 said bet. So in short, yes, governments and central banks are working overtime. But anything they do, whether announced or undertaken, as well as what may be has been anticipated like this, this infrastructure idea being given an entirely new definition. It's just not likely at all to change the underlying economic fundamentals, inflation most especially. The same fundamentals that all these parts of the bond market have learned from repeated history. And that's just Western history, by the way.

Erik: Okay. So in other words, you're saying that the global market is priced in such a way that there really is a consensus where inflation is concerned, you just don't think it's the consensus that everyone else seems to be observing in the data?

Jeff: Yeah, and I think that's really the most frustrating, disappointing aspect of this. You know, but this is nothing new either. Like the inflation argument, it happens every time there's a minor inflationary sell-off, no matter how increasingly minor each of them becomes. You know, inflation, it's made to sound like it's always guaranteed to be just around the corner, and that there's no way anyone could possibly disagree with that. Except the whole damn global bond market does. It's not just a one person here or there, it's the entire marketplace. And since that includes pretty much the entire financial system worldwide, I'd say the deflationary story has overwhelming support rather than the other way around.

Look, go to slides 34, 35, and 36, the idea that this current sell-off is in any real sense, historic and even unusual, it's just plain false. And anyone who's claiming otherwise is being intentional about it. There's even less here than a few years ago, which is less than 2013, and so on. It's even worse in bond curves and bond nominal yields inflation expectations elsewhere around the world, where there's somehow even smaller probabilities of inflation in those curves because this isn't something totally new. It does not represent a categorical shift in outlook and acceptance of the mainstream narrative.

Go to slides 37 and 38. Far from it, no matter what piece of the bond market you look at, in any jurisdiction, you can use whatever form or from whatever curve or from whatever, whichever location. The probabilities embedded in those curves, of things going right, even though they're better than they were last year. That doesn't mean as much as it might sound. On the contrary, you should be asking yourself right, this reflationary trend hasn't been so much more than what we've already seen so far.

And remember, this is eight months long now. It's not like this is a short term thing. Now, given all of the positives that seem to be happening as you've pointed out vaccines, you know, end of the pandemic is finally in sight. There's trillions upon trillions of money going directly into the hands of consumers, or at least hundreds of billions, you know, the TGA, the flood of bank reserves, so on and so on, and so on. Why hasn't the bond market sold off a hell of a lot more than it has?

And it's not, as I said, it's not like this is a relatively young trend. It's eight months old now, which is already as old as the reflationary trend during 2013, which went much farther and faster, even though it amounted to very little, which is, which was really nothing by its end. So if all of these things are enormous game changing policies and programs, why has the bond market, which is an enormous thing, including millions upon millions of the most sophisticated investors and traders, those inside the system itself. Why has the global bond market been so unenthusiastic about any and all of them?

And part of the problem is simply that we're taught that governments are in control at central banks especially. If they want inflation they can get it and as you pointed out, Erik, sometimes they don't even know they want it or know how to get it and they just go too far. And then all it takes is for them to go too far, that they just take the wrong step on slide 39, and 40. But it's just not true. The bond market absolutely knows this. As I've said, we have the last 14 years in the Western world, as well as the prior 30 years in Japan is all the empirical evidence we need. It's all the evidence of global bond market needs, that's for sure.

Erik: Okay, Jeff, it seems to me that your whole argument here is mostly about if there really was inflation, then the bond market would be selling off more than it has so far. Well, hang on a second. One of the reasons that are the primary reason that those of us who are inflationists are inflationists, is because we see the government's intention is to basically throw an incredible amount of money at everything trying to stimulate the economy.

One of the things we know they're going to do is buy bonds. So it's naturally expected that one of the things that's happening here is the sell-off that might otherwise be occurring in the bond market is not occurring specifically and precisely because of expectations of more quantitative easing, and more central bank purchases of bonds, offsetting that natural pressure that you would expect an inflation for the bond market to sell-off. Doesn't that make sense?

Jeff: It makes sense. It makes intuitive sense, right? The Federal Reserve is buying bonds, and therefore they you know, they can control the price of bonds, except not even the Federal Reserve would agree with that. If you look at any of the mainstream scholarship, or any scholarship over the last 20 years of quantitative easing, what you'll find is they uniformly say three things. Quantitative Easing doesn't impact inflation, which I think you agree with it's bank reserves, it's not real money.

Secondly, that it's supposed to perform in the expect or the portfolio rebalancing channel, and it doesn't really have much of impact there either. And so all of the mainstream academic studies say, well, it must be it lowers interest rates, right, because the central banks are buying bonds, and therefore they're projecting that bond buying into higher prices of the bonds being bought, because you hear you have a non-economic agent imputing itself upon the bond market. And yet, all of the studies say the same thing there too. There's only very limited evidence that quantitative easing lowers interest rates.

I love how the Bank of New Zealand put it. It's right there, you go there to the website right now, you can see exactly what they think of quantitative easing. What they say is that if you do a large scale asset purchase of 10% of GDP, 10% of GDP, you might be able to lower bond rates by about half a percent. In other words, what they're saying is that the market reduces interest rates far, far, far more than quantitative easing ever has. The market is in charge of interest rates, not central banks. And again, this is central bank's telling you this through all of these academic studies, and it's absolutely been the case in Japan, it's absolutely been the case in Europe, and the United States. The market sets the long term interest rates, not central bank bond buying.

In fact, there's very little correlation between bond buying programs and where interest rates are and have gone. Again, we just went through the 2013 episode, which proves beyond a shadow of a doubt that it's the market setting interest rates. Remember, Ben Bernanke's Fed December of 2013 began tapering bond purchases. What happened to US Treasury prices? They didn't go down, they went up, because the market was pricing probabilities that were different from Ben Bernanke which were leading him into tapering. So no, I don't believe at all that quantitative easing is the reason why the reflationary sell-off has been sold. So minimal and underwhelming, as I said, and by the way, what does that have to do with three month LIBOR and Eurodollar futures? It doesn't have much to do with it. There's a close consistent corroborating story across all of these global bond markets that say, we just don't see the inflation coming.

Erik: Okay, Jeff, you're citing research about quantitative easing and I think the point that you're making very persuasively and I agree completely is quantitative easing, the stuff that Ben Bernanke started doing isn't inflationary the way a lot of people like me thought it was in the beginning, I get it. I'm totally sold. I'm with you. But the point that I and other people are making, Jeff, is it really feels like the government is changing up its game dramatically.

We're not talking about supporting financial markets with low interest rates, which was Ben Bernanke's goal. We're talking about politicians trying to figure out how to use this money printing ability of the Fed to essentially create transfer payments to buy votes, to directly stimulate the economy by pumping money into people's checking accounts through things like universal basic income. It seems to me like that's a fundamental apples to oranges different game than the 2009 through 2017 quantitative easing brought to you by Ben Bernanke and Janet Yellen. It seems like it's a totally different game that's on now.

Jeff: Yeah, and I would not agree with that. I would say that it's an escalating series that we've already seen happen in history, recent history.

Erik: So you think it's the same game?

Jeff: I actually think it's been done before and proven to be deflationary not inflationary. Money finance, fiscal expansion was practiced by the Japanese in the 1990s and into the 2000s. And it did not lead to an inflationary breakout either. I guess why I say when you look at MMT, MMT looks a lot like Japan and because of the intrusive nature of the government, because of the wasteful nature of the government, it ends up being deflationary not inflationary. So to me, this does not represent anything that we haven't seen before, that we don't have empirical evidence with.

And by the way, the Bank of Japan or the Government of Japan used any number of ways to inject funds directly from postal savings, which was money that was the money financed part of it through the Trust Fund Bureau. And all of those, you know, I think there's something like 30, some government agencies where money was taken from the from the actual savers and repurpose and redistributed into the real economy directly to the real economy off budget. There was a second budget, they even called it the secondary budget in Japan. And it didn't lead to an inflationary Inferno, it didn't lead to inflationary excesses, it only led to more of the same which was lack of growth, lack of inflation, which was exactly what the JGB market had been pricing the entire time. That this was not going to lead to anything different, because it wasn't really anything different.

The problem is, the sickness is, it's in the real economy and that's just not something that governments have the ability to fix, they can try to circumvent those problems. But all they do when they're trying to circumvent problems in the real economy, oftentimes, they make those problems worse. They exacerbate the issues that are already existing. You know, when you look at any of these DSGE models that assign positive or even greater than one multipliers to fiscal spending. They don't realistically equate to what may be negative multipliers from all of this fiscal stuff.

So it may be that you get a short term burst of activity, but actually doing more longer term harm than you think. I mean, just universal basic income, for example, you're paying people to not work. That's going to be deflationary, over time, not inflationary, because you're ruining, you're making, not necessarily ruining, but you're exacerbating existing negative problems. And I think that the marketplace understands this having seen it happen up close and personal in Japan, for a very long time. That it knows that, yeah, it sounds like this is something very new and different. But it's only very new and different to people here in the West.

Erik: Well, Jeff, I've got to hand it to you. We've been looking for months for a deflationist who could really articulate a compelling argument. And I think you've done exactly that. Before I let you go though, I want to bring our listeners up to speed. You know, a lot of people remember the Eurodollar University that you and I did as a podcast series a few years ago. You and our friend Emil Kalinowski have taken that work to the next level. You're doing a regular podcast on the subject of Eurodollar University. Tell us a little bit more about that and what you do at Alhambra Partners?

Jeff: Well, I do most of the research. I get the chance to dig into some of these details and try to present them in a way that makes sense or at least has an intuitive framework behind it that people can then understand what's really going on in the monetary system. You know, why aren't bank reserves money and things like that. And yeah, you're right, Erik. That's why I always love coming back on macro voices because it was you and I who kicked this whole thing off, trying to really put together a comprehensive view of this Eurodollar system and put it out in a way that the public can relate to it and it's really, it's a difficult chore.

So I've had to bring in a Emil Kalinowski and a few other people behind the scenes to try to do that. And so we've created this regular weekly podcast Eurodollar University is Making Sense where we try to look at some of these things like Eurodollar futures, for example, how can we explain them? How can we explain, you know, the reflationary sell-off in a Eurodollar framework? And that's really what we've been trying to do, and what we're trying to expand it over time so that we can reach some more of the more esoteric and what I think is the fun stuff, like, you know, Eurodollar futures curves is a perfect example.

Erik: Well Jeff, we 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.