Juliette Declercq: Are Cyclical Indices Positioned To Outperform?

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Erik: Joining me now is Juliette Declercq, founder of JDI Research. Juliette has prepared a slide deck for us for today's interview. Listeners will find the download link in your research roundup email. If you don't have a research roundup email, just go to our homepage macrovoices.com. Look for the red button that says looking for the downloads. Juliette markets have been directionless and a little bit difficult for the past few months. Now you specialize in splitting out underlying trends from noises. So how about if we start with your macro diagnostics since we last spoke?

Juliette: So let me think about them. When we last spoke, I think it was in March when we were nearing a macro inflection point. And you've got a great timing in reminding me on your show Erik because I think we're nearing another inflection point, which normally should mean good trading opportunities. So let's start with what really happened since we last spoke. If you check chart 1 and 2 of the chart deck that I've produced for your listeners. You will see that the reflation trade which started on the COVID vaccine in early November 2020, and which consensus strongly believed was going to be the main theme in 2021. As now fully unwound, and unsurprisingly cyclical stocks and real yields were the main casualties. It's also interesting to note that the peak in real yields and cyclical outperformance also coincided with a global demand peak, as shown by the peak in the global PMI survey.

So what really happened? I think the answer is that investors grew too comfortable as normally happens in earlier but this year was like a particularly was different because of like the massive leverage that was available in market. So I think investors grew too comfortable in big size with the narrative of the grand recovery trade and the view that cyclicals would basically sail into the sunset. When consensus is overwhelming, it doesn't take much to disrupt trends. And inevitably, three things ruin the party. One, higher production costs and persistent supply bottlenecks curtailing company's growth potential. Two, the secondary effect of higher prices suppressing consumption. And three, obviously the rise of the Delta varient this summer, depressing animal spirits just as most of the developed world we're starting to see light at the end of the COVID tunnel.

So um, let me start here with the global supply chain crunch. Instead of seeing an easing in 2021, we actually experience a worsening far beyond the ones in 2020. We can blame a front loading of Christmas orders and delta and use port closures in Asia. I was speaking just last week to a luxury perfume maker in France, and they would have had the absolute best year ever in 2021. If it wasn't for the fact that they can't deliver on orders. It's not the glass bottles that are made in France or Italy. But what they're missing is basically the plastic tops that are made in China. The issue is, is that the explosion of globalization in the past two decades. Goods production depends on intricately intertwined global supply chains. I'm not teaching you anything here, a missing link and delay prediction tremendously. And persistent semiconductor shortages is another prime example.

Meanwhile, global manufacturers face bidding wars for space on vessels pushing Fred rates to records as you can see on chart 3. So even if you did manage to get your orders shipped, cost pressures remain acute and we are yet to see a peak there. There is really no secret. You get price inflation when the money supply - which tends to lead global demand - rises much faster than the supply of products and services. And as shown on chart 4, the Global Bottlenecks index has now peaked, but it remains extreme historically. So the question going forward is whether prediction will eventually catch up to strong demand as the supply crunch eases, or whether inflation will eventually kill reflation in the stagflation scenario that we have been pricing since May.

Erik: Okay, Juliette. So what's your take on the subject of final demand being heavily constrained by higher prices? Do you agree with markets pricing of inflation being transitory because higher prices eventually curb demand as the supply side normalizes, leading to a supply-demand rebalancing and a return to the great moderation.

Juliette: Well, to be fair, this is something I really focus on in the past few weeks, and my initial answer would be that indeed, it would appear that global demand has suffered a mortal blow. In Asia, for example, new orders actually fell into contractionary territory for the first time since July 2020 and inventories have started to normalize. That plunge, the manufacturing sectors leading indicator for the region into the danger zone and raising Red Flags Over the cyclical outlook. And that's something you can show for yourself on chart 5 of my chart deck. Of course, there is good news there as well because normalizing inventories in Asia should go a long way to stop alleviating supply chain constraints in the West. But on the same chart, you can also observe that all manufacturing leading indicators have indeed peaked and the natural conclusion is that softer demand trends should indeed allow a return to a macroeconomic equilibrium, which guarantees the 2021 burst of goods inflation is a one off that would fit the feds transitory narrative and that's something you can see on chart 6.

Truth be told, the most recent consumer surveys do fit this narrative. If you take the Michigan index, which was the first to smell troubles, because its granularity gives a good read on real income expectations, rather than just income expectations. So you realize that elevated prices are as much of a drag on sentiment as the Delta valiant, which hit hard this summer. That's something that you can see on chart 7. So basically, ordinary folks are fretting far more about their purchasing power than about their jobs. And the particularity of this crisis is that it did not rebuild, but actually initially killed purchasing power. So to your initial question of whether inflation has killed reflation, it would appear that markets are right to price that it is indeed the case. And on this look no further than the last Conference Board survey, which basically joined the Michigan survey in describing a situation where the consumers purchasing power is a problem with purchasing plans falling below their 12-months moving average for all durables, that's on chart 8. But really, I would argue that there is a lot more to inflation than the good story.

Erik: Juliette, it sounds like you're implying that markets are missing some important piece of this macro puzzle. Is that right and if so, which one? And do you know what the answer is?

Juliette: So I'm trying to, that's what I am trying to develop in my last report. Just two things. Firstly, that's two charts that I've added for your listeners. That's charts 15 and 16. The first one is the ISM manufacturing, which in fact, was much more optimistic than markets as to the fate of the manufacturing sector in the US. And the truth is that I've been shocked by the strength of demand if you're looking at business survey, rather than consumer survey despite higher prices. The business survey actually point to production catching up to strong demand, as supply bottlenecks start easing, rather than the opposite. And secondly, the global services sector is a bit weaker this summer on the Delta variant, but leading indicators remain historically very strong. So there is a case to be made that services will drive global activity stronger, but that manufacturing will not collapse and be as weak as some of the consensus expects.

But more importantly, I want to come back to inflation. There's basically two types of inflation. There's the so called first round inflation, which basically is higher prices. And this one is clearly self limiting. All else equal, higher prices end up curbing demand, and indicate mean reversion in prices ahead. So that's never something that's really worrying for a central bank. And to be objective, this is all we've seen in our investing life, because central banks are dead paranoid about second run inflation, and tend to kill it in the nest. Why? Because secondary effects from the initial inflation spike come by a higher wages catching up to higher prices. That's the processes called a wage price spiral. And the problem with the wage price spiral is that it is self perpetrating, rather than self limiting like the first round would be because real wage growth feeds into higher demand and then back into higher prices.

So this means that second round inflation is actually reflationary whilst the first round of inflation is contractionary. You get the drill. Secondary effects are much harder to control. And it results that most central banks have tended to lean against true reflation for decades, which also somewhat explains why we all salaries have been diverging from productivity and the reason why purchasing power has been curbed so drastically over the past few decades. What I'm arguing today is that the COVID crisis has sparked a macro paradigm shift away from a world order that I just described, that had become basically unsustainable, because of collapsing purchasing power.

Why? Well, think about it, because we've entered a new era for the especially for the US labor market. It's a bit of a similar effect to the world war two effect, which started the trend in Europe of women joining the labor force as a result of the initial squeeze in the male workforce, simply because of a large share, you know, basically being busy in the trenches. In the same way, many US workers today are having a complete rethink about their dead end jobs, which explains why the quit rate is surprisingly, at all time high, just after a downturn and that's something you will see on chart 9. I strongly believe that perspectives are changing, priorities are shifting, and after being forced to stay at home, burned out by having to educate kids at home, but at the same time, flushed with savings. Workers now have the luxury of having a deep thinking about what they really want. So what do they really want? Continue to work from home? To be away from big cities? Get vaccinated to get a job? Are they desperate to go back to the office? The problem is that it basically lowers the labor force and increases structural unemployment.

The second thing is that this sort of like trend also combines with baby boomers retiring at a faster clip than pre-crisis. And surveys also show that 3 million over 55 are now considering early retirement. I think there is also and most definitely the effect of easy money, you basically find that all the workers that actually had savings, often their retirement portfolio exploded over the crisis. And I'm hearing more and more younger workers actually find that trading crypto or buying equity dips is a lot easier than getting a traditional job. So I think it's somewhat naive to blame the slower than expected employment recovery on the supplementary unemployment benefits, which are now expiring. I believe that labor shortage will persist for years to come and that structural unemployment will move higher. And the result is that against all expectations, Phillips Curve effects may come back with a vengeance.

Erik: Well you know, when trading crypto with no trading experience seems more opportune than getting a job. What could go wrong?

Juliette: Exactly.

Erik: Juliette, I hear you on the labor shortage. But isn't this just another piece of the stagflation puzzle? I mean, after all, consensus is strongly of the view that weak demographics and the shrinking labor force is what's actually depressing real growth potential and we've had full employment in the past with a dead Phillips Curve.

Juliette: Erik, I think you're absolutely right on the weak demographics. But there are two ways to grow aggregate earnings. And obviously, we've forgotten about the two ways because the last three decades, I've seen no increase in real earnings. But the fact is that you can grow aggregate earnings by growing aggregate hours worked from employment, or by increasing hourly earnings or real earnings. And my belief is that the labor squeeze, that the labor market squeeze that we're currently seeing will lead to higher real wages because the large increase in workers bargaining power is actually this time combined with exploding inflation expectations. And that's something that you can see for yourself on chart 10. Basically, it's one thing to not use your bargaining power with no inflation at full employment. But it's a completely other one to remain silent when your rent is expected to rise at double digits next year. So I'm convinced that persistently high inflation expectations will drive workers to use the increased bargaining power to defend their purchasing power.

In our last interview, I argue that the pandemic's fiscal giveaways would buy workers the serenity to rethink their return to the labor market. And that's such nonurgency, if we can say, would increase their bargaining power, which is basically a side effect of socialism, something that I know quite a bit about being French. It's already happening in fact. Workers are now seeking to benefit from the hot labor market in the US, and especially in the most disrupted sectors like leisure, and hospitality, and transportation, and warehousing. It's really interesting to see that the recent survey by indeed, showed that COVID fears are no longer the main reason for avoiding job hunting in the US. Instead, the nanny states financial cushion is exactly what keeps the couch comfy. So we have an urgency mismatch between employers and job seekers. And that really explains the acute labor shortage, despite an employment-population ratio, which is still 3% lower than pre-pandemic. In my opinion, that's really a source of future wage gains. Also, don't forget that the pandemic as laid bare the West's overreliance on the global supply chain, and the race to re-shore production and jobs also, is now fully on.

This will also tighten domestic labor markets further, and buttress worker's bargaining power domestically. But imagine if Biden's infrastructure bill passes, even a watered down one. If you look at the most recent Atlanta Fed wage growth tracker, which I'm showing on chart 11, you can see that it's old, it's already breaking higher. What's interesting is that it's been used in the past few months, by many macro pundits to argue that there was nothing to worry on the wage side. And that's also something that the Fed has been looking at, to argue that it doesn't have a wage issue. What's interesting is that job switches are seeing most of the wage gains, with the younger cohorts and lower skilled workers also pulling more than their usual weight at this stage of the labor cycle, and they're normally catching up to the cycle, this time, they're actually leading. So this pandemic induced phenomenon will persist, especially with voters in the DM voters moving resolutely to the left. And on that I will avidly watch this week's election in Germany. Of course, you also have access savings that are still plentiful and so labor labor supply may actually be tightened permanently.

To gauge the effect because, of course, what will really matter next year is where is NAIRU (Equilibrium)? At what point can we decide that the US is back to full employment. I think to gauge the effect on the NAIRU or equilibrium unemployment rate, think that unemployment is around 4% in the UK versus 7% in France. Well, you know, what the main differences between the two countries that I know very well, is that the higher frictional unemployment is that there is a much higher frictional unemployment in France, where you get 80% of your salary for two years when you lose your job, versus basically a kick in the butt if you're working in UK. You therefore have to jump on the next job if you want to continue paying your rent.

Going back to the US, real wage analysis shows that workers are already playing a stronger hand than inflation. Many macro commentators are looking at year-on-year increase in real wages and arguing that it's negative, but I think it's you know, you can't look at, you know, August versus last August numbers because of base effect. So what I'm showing on on chart 11 is actually the real wages but not growth in real wages. And what you find is that wages and services sectors, real wages I'm talking here have increased 3.1% over the crisis since early

2020. And you've got a 6% real increase in leisure and hospitality, which is even beating the 5% real increase achieved in financial services. So it's interesting here to see a real wage catch up in the service industries, which is also the lowest paid sector, like hospitality or care services. And it's interesting to see that we are effectively already redistributing wealth through a higher wage share in those sectors.

Now, that's not something that happens only in the US. Consider Germany. The most important factor there in the wage dynamics is the annual wage negotiation rounds. So in those rounds, trade unions are basically now basing their claim on current inflation. So it was 3.9% in August, but it could easily reach 5% in the coming months before leveling off. So rather than you know, considering the ECBs 2% target as it was in the past. They are now already using realized inflation. So if unions managed to pull this off, it will structurally shift the inflation dynamic, so one of one-off hikes perpetrate through higher wages. The same thing is true in France, wages are set there at the company level so it's less of a macro phenomenon. However, a labor market recovery is already in full swing. The job centers saw offers jump 10% to new record highs this month, with demand exploding for restaurants and also in the food, transport, and health sector. Also, I should mention that half the offers are long term contracts, which really emphasizes employers prevailing optimism. Finally, you have to consider the UK because where labor shortages are possibly the most acute, due to the effect of Brexit. There, the Bank of England currently estimates that the underlying wage growth is trending around 5%.

Erik: Okay Juliette, so as I assimilate the things that you're saying, it sounds like you think real wages are going to have a strong tendency to rise. But the question is going to be whether or not the Fed is going to let that happen?

Juliette: Exactly and obviously, that's what will drive market as well. So firstly, let's think about those who will exit the labor market permanently, the boomers. They basically sit on a disproportionate share of total household wealth in the US especially and that's something you can see on chart 12. So for them, retirement, we'll see them spend their wealth. And that should mean that their demand should be supported, even outside employment. Meanwhile, real wealth will transfer the younger generations through inflation, and obviously wage inflation if it happens, and that will be boosting aggregate demand in the process. The thing is that a hot labor market tends to lower income inequalities leading to a greater aggregate propensity to spend, rather than save and boosting aggregate demand in the process. Inflation eats away at capital holders real wealth. You know, let's think about it only the top 5% of the risk appetite to manage their whole wealth actively rather than hold it mostly through cash. And eventually, that will benefit the working class if their income grows and stops beating inflation, something that we haven't seen in the past 30 years.

So I think the Fed will be late to recognize and act on this price-wage spiral because it's largely virtuous. And as proof of that argument, I'd like to cite a recent study which was presented at Jackson Hole this August, just a few weeks ago. It's entitled, "What Explains the Decline in R*? Rising Income Inequality Versus Demographic Shifts". The study basically suggest that the Fed is becoming aware of what I've been arguing for years, which is that income inequality goes much further than demographic shifts to explain collapsing final demand and obviously, it's corollary the real equilibrium rate. So more money in fewer hands axes a nation's marginal propensity to spend out of both aggregate income and wealth. Indeed, the study reckons income inequality is really what caused the global savings glut and the Kansas City Fed estimates that high income households now save 3 to 3.5% points more of national income than was the case in the 1980s.

Obviously, lower immigration and weak demographics will continue shrinking the labor force. But if higher wages boost aggregate earnings nonetheless, the macro economic and market dynamic may radically differ from the past few decades. So I think the collapse in yields over the past 20 years results from both weak demographics and the crumbling wage share of national income. As the former gets fully priced and the latter reverses. I think there is a case to be made that yields will pursue their recovery higher than pre-pandemic levels after the ongoing cyclical dip and that's assuming that wage share duly mean reverts. And if you need to convince yourself on that, check the chart 14 of my chart deck, which indeed, hints that equilibrium rates are closely linked with inequalities and the share of global wealth which goes to the working class.

In short, secondary inflation effects are absolutely necessary to consolidate post-pandemic reflation. Indeed, while higher goods price are double hedged swords for reflation, raising inflation, but shrinking purchasing power. Higher wages are an unquestionable boon to the underlying strength of the economy, especially at this macroeconomic juncture.

Erik: These musings on macro have been absolutely fascinating. But as you know, we've got a tough audience and fascinating is not good enough. You are in the business of linking these fascinating insights to actual trading recommendations and strategies to make money on this stuff. So what's your thinking? As we look ahead, where's the trade here?

Juliette: So my bottom line is that labor supply will slowly recover, but not to pre-pandemic levels. This should keep the Fed dovish why because basically, it will take a long time for unemployment to drop back to pre-crisis level. So this should keep the Fed dovish. As far as rate hikes are concerned. Don't forget that the Fed is committed to not hike before full employment before the economy returns to full employment. So in the process, the urgency mismatch between employers and job seekers will prop up wage growth beyond the initial price boost, ensuring that the initial burst of inflation broadens to the services industry. I think that's going to mean a slower return to full employment. And it strengthens the hands of those employed and keeps the Fed easy and increases the chance of lasting second run effects from the initial spike in goods prices to higher wages. So in this vein, I was not really surprised to see that August NFP fell well short of analyst expectations. I think it reflects parly the Delta variant hitting close contact sectors, such as leisure, hospitality, and healthcare.

But it was much more informative to see the continuation of earnings growth through wages. So after all is said and done, an economy can produce aggregate income growth and fuel final demand in two ways, creating jobs or boosting real earnings from such jobs. Of course, markets have previously tended to prefer jobs to wage with growth tends to signal inflation is starting to snowball, perhaps warranting tighter monetary conditions. But today, the Fed is looking for jobs and is rightly turning a blind eye to a virtuous waste driven reflationary cycle. But in the end, what markets really fear is normalization and monetary normalization in a down cycle. But as the contractionary effect of higher goods starts moderating, the Fed should not and probably will not impede the true reflationary cycle which will see income gains catching up consumption prices and reboot the cycle. In turn that will allow for normalization to get priced in a relatively market friendly way into 2022 at least.

So that takes me to what you really want to hear, which is market wise. I think inflation killed reflation from the beginning of the second quarter, triggering a correction in the global yield uptrend and a curve flattening. I think the near future should see transitory inflation moderate but stay firm, especially compared with the past decade. I think that means that markets are not right in pricing that spot breakevens will be converging to lower forward breakevens. I actually think that forward breakevens are too low. So, I'm recommending long for what breakevens. Also, the second one of inflation should be friendlier to the working consumer who should be able to use his newfound bargaining power to achieve substantial real wages gain. So I expect capitulation on the cyclical low narrative into the ongoing Evergrande turbulances and the Fed.

Depending on China's monetary stance, as economic weakness starts putting employment at risk, I think the end of the ongoing cyclical lull should prompt cyclical indices to erase the past quarters underperformance and low medium term real yields to come way off their lows and start trending higher again in a move that should actually re-steepen global yield curve. Already, you can see that in the ongoing turbulence. And with the global growth surprise index continuing to collapse lower, 10-year US yields have actually diverged and stabilized, hinting that the cyclical low may be fully priced. Personally, I'll be looking to go back, short tenure duration into the current risk of dynamic. And I'm also looking for dollar upside to fade again quickly. I'm basically looking to go back long, cyclical in the index. And I'm looking there at European banks, which is super cyclical, but also our 2K small caps, which I think should be, you know, coming out of its five months consolidation range to eventually break higher.

Erik: Well Juliette, I can't thank you enough for a terrific interview. But before I let you go, I want to talk about what you do at JDI Research. Now, when I first met you, JDI Research was exclusively an institutional advisory firm. I like to think that MacroVoices has played a role in persuading you to open up your client base a little bit to some high-end retail. Tell us a little bit about what you do and who it's available to.

Juliette: So with JDI research, I am very focused on helping institutions. But I also have a lot of family offices and high net worth clients. What I'm doing is helping them see through the noise to trade the underlying trends with conviction. We've been going for six years now, and our process has proved valuable to clients. As always, I like to thank you Erik, for having introduced me through your show by giving your listeners a once in a year offer on a JDI subscription. So get in touch either via email at juliette.declercq@jdiresearch.com or follow me on twitter

@JulietteJDI and I shall ensure that you know you get the absolute best deal on a JDI Research subscription.

Erik: Well Juliette, we look forward to getting you back on the show for a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.