Jeroen Blokland: Inflation, Bond Yields, Portfolio Allocation & Bitcoin

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Erik: Joining me now is Jeroen Blockland, who is founder and head of research for True Insights, a new investment research platform focused on multi-asset investors around the globe. Jeroen has produced a fantastic slide deck to accompany today's interview. Registered users will find the download link in your research roundup email. Now if you don't have a research roundup email, that means you're not registered yet at macrovoices.com. Just go to our homepage, look for the button that says looking for the downloads at macrovoices.com.

Jeroen as we dive into this, I'm really excited to get you in the program. Being in Rotterdam, you've got obviously a European perspective. Our Federal Reserve has been telling us over on this side of the pond that hey, don't worry, this inflation stuff is just transitory, it's not going to last. What's your take on inflation? Where's it headed? What does it mean?

Jeroen: Yes, well, thank you for having me. And to get right into the topic of inflation, which is, of course on everybody's minds. So basically, you have these two angles to look at it. First, you look at these, mainly the three big components that add to inflation in recent months. The usef cars, airfare, and hotel rates, and you see that they have peaked. So the year-on-year change on these items is still very large. But for example, used cars, they fell in price one and a half percent in August. So from that angle, I think most central bankers are pretty convinced that the inflation being transitory is still alive as well. And also, if you look at page nine of the slide deck, if you look at the flexible versus sticky CPI, and this is calculated by the Atlanta Fed. You see there in the chart that the core sticky CPI is actually not much higher than the long term average. And also, if you look at it from 2015 onwards, it's actually in the middle of what it has been. So if you argue that this is only about flexible prices, and again, used cars prices, airfares, and hotel rates are in that category, of course, then you can say inflation is transitory and also you see in this chart that even the flexible component is coming down a bit.

So from that standpoint, you could argue it is transitory. And I think also you should take into account that over the last 10 years me included, we have thought of higher inflation many times, but it never came. And this is because mainly there are some big deflationary forces at work, globalization, technology, and so on. So the odds are also against you and I think the base case of the Fed are more favorite. Having said that, there are a couple of indicators that point to continuously or longer than expected, higher inflation rates and perhaps not 5% or 6%. But maybe a longer time in above 3%, or even 4%. A couple of these things I want to mention is first, if you look at inflation indicators, so the ice and prices paid index, it's close to 80. That is down from 90, but it's still historically high. If you look at the latest Empire State survey, the prices received component is at a record high. And it has a very strong relationship with, among others the core PCE, one of the favorite inflation integrator of the Fed.

And two other things I would like to highlight. First is owners equivalent rent and you can see that on page eight of the slide deck, you see there's a clear relationship, obviously between owners equivalent rent and house prices. Well, we've got another data point on house prices just today. So house prices are up almost 20% and this is what the green line shows. And you can also see that owners equivalent rent, they take about 18 months to catch up with these housing price appreciation. And that means that from now, and let's say 12 months, it is very achievable, that this owners equivalent rent component of the CPI basket will rise to above 4%. Now it has a weight of 25%. So you can do the math. So this will be a upward pressure on inflation for at least another 12 months unless the US housing market collapses. And that is not the case, I think we are close to the peak, but it won't collapse immediately. So this is also a thing to take into account.

And finally, and that's on page seven, there's also a thing called the medium price rise and this is just the middle of the whole range of the whole U.S. CPI basket and you take the middle price increase and in August that was 0.34%. And you can see by the arrow, that was the biggest increase monthly increase we had since February 2007. You can also see that the month before that July 0.3% was also relatively high. So the median price level, I think something that central bankers would also look at is increasing at a faster pace than we have seen for a long time. And I think if you add these things together, and the fact that we are seeing supply chain disruptions getting worse and not less, or they're actually getting worse well, not perhaps 5 or 6%. But that we see, clearly above average inflation for let's say, the next 60 to 12 months, I think that is that is, the odds of that are not low. And that is why we have a somewhat more nuanced stance on this whole inflation is transitory narrative.

Erik: Now, let's suppose that you're right, and that there is more inflation than central bankers are currently reassuring us that there's going to be. I'm not sure that means that they don't believe there's any inflation coming, they bluffing a little bit. But what happens? Let's suppose that you're right, and it turns out 6 or 12 months from now that the inflation wasn't transitory, and suddenly they just can't, you know, keep pretending it's not there. What do you expect in terms of policy response at that point?

Jeroen: Yeah, that is, of course, the big question, because about Powell has done until so far is being very explicit about his and the feds expectation on this transitory story. And even today, other central bankers, Lagarde today, she said the same thing. So they are very confident that this is transitory. And that means that it will first of all take a long time is my guess, before they will act. So my guess is that if inflation is higher than expected, for a couple of months, they will not move. And also at the last CPI numbers, of course, helped them because the core CPI fell below 4%, which was unexpected, so that the whole narrative lifts for at least another amount, you could say, but at some point, my guess is that you will see this ending up in the dotplot. So far, what Powell has done, I think, pretty good job is to split the fact that they will taper because that is one thing.

But the threshold, as they say, for rate increases is much, much higher. And I think that the dot plot, which is updated every three months, of course, in the end will provide more clues that some of the FOMC members are taking this hole that is not so transitory into account by lifting their dots. And this is also the point, if you look at the dot plot, which is shown on page 6, you see it's very benign. So in 2024, the average or the median forecast for the Fed target rate is 1.75%. That means by then it still implies negative real yields, because the inflation expectation of the Fed are above 2%. In each of the forecasting, yes. So my guess is that once FOMC members are starting to leave this transitory idea, that they will reflect it by increasing for the years 2023 and 2024, they will increase their dots, and that will then be the first clue that the markets get. And I also think that markets will struggle, when these medium targets go up significantly.

Erik: I want to talk about the supply chain disruptions that we've seen as a result of the pandemic, because frankly, if you think, you know, kind of intuitively, you'd expect that those supply chain disruptions would be worst in the beginning, right? When the pandemic hits, and nobody saw it coming, and then everything's thrown out of kilter. Then you know, after a little while, you'd expect things to kind of get under control, and those supply chain disruptions wouldn't be an issue anymore. It almost feels to me like this history is playing backwards. That the supply chains were not really as disrupted, as I expected them to be back in 2020. But it seems like now we're starting to get a lot of things where people are just saying, yeah, we don't really have a good plan for what we're going to do about the you know, the lack of widgets in order to finish building whatever it is. Lots of things that have been put on hold because one component is not available, and nobody's sure when it's coming. Where's this all headed?

Jeroen: Yeah, good question. And also I think, a very good reflection of what is happening and so, for supply chain disruptions, there is always the case you can always say this is tension to authority, because if prices go high enough, then supply will react. Right? So the thing is that why is this not happening now and I think that in some areas and and today, I think the energy complex is a good example of that, that it reflects not only what happened during the Covid-induced shock, but also in the investment in certain areas. And of course, energy is one of the biggest examples because of this whole sustainability drive. So I think it's also the swift response of policymakers, both fiscally and monetary. Also the massive speed of the recovery now reveals this longer term investment rent is reflected now in those numbers. At least that is what I think.

We should also take into account, of course, that supply and demand have been distorted. So but you said I would have expected this earlier, we have had had Covid related setbacks, of course. That in some areas, we had new restrictions, mobility restrictions, lockdowns, and things like that. So there was always a period, where demand also was limited for a while before getting on and now that most of the bigger economic blocks are open or almost open, you see that this is all coming together. And on your question, where does it lead us? So, I think we have to take into account and it was, this is for a long time, not my base case, but that you will see an energy crunch potentially, in any case, the odds of this happening are rising pretty quickly. If you look in Europe, and you look at electricity prices, and natural gas prices, these are going through the roof. And also in the chip industry already. It's now said that for months, for months, not weeks, but for months, these delivery times will impact the global economy.

So also Goldman Sachs, they suggested that no less than 169 industries have been negatively impacted by the delivery times. Car manufacturers, so it's now estimated that they will produce 7.7 million less scars than anticipated and they will lose this year, a combined sales of more than $200 billion. And the thing is, and this is why the upcoming earnings season will be so important. Until now, all of these companies have said we will make up for that later. But I'm wondering if they can say that now, because of the widespread impact of these supply chain disruptions. I think it's very difficult for Volkswagen, for example, where I've said that, that they will make up for this, the lost production, and this year and maybe even the first quarter. And then the thing is that if you have a price-to-sales, that is record record high, I think that could be a moment when equities start to struggle because investors have to get there. They are not convinced that this catch up will be in a couple of weeks or months. But perhaps it will take some quarters. And I think that there'll be a big test for equities for investors given that price-to-sales ratios are very, very high.

Erik: Let's talk about what's going on in the stock market generally. We've seen finally a little bit of weakness in the last few days. But you know, until then, despite this whole pandemic, we've basically been just new all time high after new all time high. What's going on? Is the market just looking beyond this or why is the sentiment so bullish given what's going on in the world?

Jeroen: Yeah, so the sentiment was extremely bullish and now we are started to struggle. So I think one reason why we have seen these drawdowns and they are shown on page 12. So the US equities, so the S&P 500 index, it has seen four episodes of a 4% drawdown before recovering quickly. As of today, we are down 2%, we are back again at that 4% level. And until so far, the recovery was rather Swift. I have my doubts if this is going to be the case this time, but what we have seen until very recently, and that is on page 13, just as an example. There have been massive, massive flows into equities. And if you look at this chart, and no other calendar year comes even close to what has been put into equities this year. Unless you want to be seriously in the weight, you have to invest these kinds of amounts. So there has been this driving force for flows and also in the whole TINA narrative that there is no alternative to equities, driven by this massive liquidity boost.

Also, what we have seen until so far is that earnings per share numbers have increased dramatically. So every time you could hold up the story, okay, but companies are growing in these lofty valuations. Earnings growth is 50% year-on-year. Growth is still accelerating. So you could get away with this whole there is no alternative and everything is fine. I do think that if you look at and coming back to the previous topic of the supply chain disruptions. Things are changing a little bit because how temporary is this inflation, the same story, how temporary is it really? Even some of the central bankers are starting to discuss this a little bit. So if I look at some of the data that we look at like momentum, and also the US Dollar Index. The moving averages, it does seem that sentiment is finally weakening a bit. And if you add to that, since 1980, the medium drawdown of the S&P 500 is 11% and only two years since 1980, we're less than 4%. Yet, it's not that unlikely that we see a bigger drawdown coming. And I think this will be the biggest test we have seen so far. I do not rule out that we go back again, butit does look a little bit less confident than before.

Erik: And the driver for it looking less confident. Is that mostly because of the taper announcement or is it something else that's driving that change in sentiment?

Jeroen: If you look at the price action today, I really think that this supply chain disruption leads to higher cost or inflation, less production in a time when the economy is already cooling, which could be have been expected of course. I also think that this is an important factor that the visibility for sales and earnings is becoming less and I think that worries investors as well. I don't think that the taping on itself is that important. First of all, if you look at the stock of liquidity that remains extremely large, so the flow will go a little bit will be become a little bit less. But if you look at other parts of the world, so the ECB for example, they also want to enter their emergency program, PEPP. But they already are talking about adding to their regular program, APP. In China, you should expect more liquidity because what they did on the regulatory clamp down the whole China evergrande thing but also if you look at economic data. So I think it's more the cloudiness that we have not seen for a long time, it was always clear earnings or recovery, we just don't know about how much but it's very strong. Valuation will go down and liquidity and central banks are relatively quiet. But I also think that it is more difficult, where next for equities, given these valuations.

Erik: Jeroen let's take a look at page 11, where you've got your balanced global multi asset portfolio, I'm curious about a couple of things, obviously, you've got a very strong equity allocation. As a professional crude oil trader, I can't help but having my feelings hurt a little bit that you've only got a 3% allocation to commodities, what's going on there?

Jeroen: Yeah, so maybe a bit of information on how we derive these portfolios because I think that is a little bit different then perhaps other asset managers, or people that construct multi-asset portfolios. So what we do is, as a starting point, we look at the actual investable, I should add market cap of all asset classes that are out there. So there are two papers I use for that they update this data every year. So every year you get new data and information on the relative size of the different asset classes. And this is our starting point. And the reason why we do that is because if you do the traditional way, a mean-variance optimization, I have to make all kinds of assumptions. And even then I get corner solutions and I don't want to do that. So we looked at what are the diversification benefits of a portfolio based on actual market rate, just weight, just as an equity index like the MSCI for example, and then look at how you could tweak that. But you already see that what we call the diversification benefit is really, really large, if you just start with this portfolio. And from the technical point of view, we could add commodities or reduce it quite dramatically if we want to, but the starting point is the total investable market cap of the different asset classes.

Erik: And is that an indication that your allocation here of 2% to high yield or junk bonds. Are you recommending that allocation or are you just reflecting that that means that that asset class exists and has that allocation for the rest of the market?

Jeroen: Yeah, so high yield is perhaps not the best example because we are neutral on high yield bonds and that means that it will get the weight that it has in the global multi-asset portfolio. But for example, commodities actually has an overweight. So that should make you a little bit more happier of 1% here so this portfolio combines the starting point and that are the market caps of these different asset classes. And then it adds our active weights, our active positioning, so that is what this chart reflects.

Erik: Okay, what are the other parts of the chart that have been affected or how has your positioning weighted or affected these allocations?

Jeroen: So first of all at this point because of the uncertainties, we have been pretty close to home. But what we have a position in terms for quite a while is we are long developed market equities against emerging markets equities. And that is not just because of the China regulation clamp down that is going on. But also, because of weaker fundamentals in general. You also see that the most common way out of this Covid crisis is vaccination and emerging markets lag from that perspective. Also, if you look at the bond side of the portfolio, and so we are underweight both developed market treasuries and global corporate bonds. And the reason for that is pretty straightforward. First of all, we do think that bond yields are artificially low because of monetary policy. So if you reverse at least some of that policy, you should see an upward effect and that is exactly of course what we have seen in the last couple of days. But also, if you look at, for example, the spreads on corporate bonds, they are well below 100 basis points, that leaves you with a yield of roughly 1.6%. And with a duration of seven and a half years, they provide zero buffer against any normalization of bond yields, even if it's a little bit. So also because of the supply chain disruptions we have put the end debates what we have put in developed markets, recipes and global corporate bonds into global inflation-linked bonds, because we think it's feasible to have some kind of inflation protection next to commodities, which also, of course, have a high risk profile into your portfolio. And I think that that are the main parts of our position.

Erik: Let's talk about last week's FOMC statement and what its implications are. Is this a hawkish impact that we should expect and where is it headed?

Jeroen: Yeah, so we've wrote a little piece on that and we say, short-term hawkish, longer term dovish. And, of course, the hawkish part was that, especially in the press conference, Powell made it pretty clear that they are aiming to start soon, and which is most likely November with tapering. And also that they are looking to end that taper around the middle of next year.

And that would make it quite a bit faster than the last tapering that we have seen. So from that, from that perspective, it looks somewhat hawkish. And also if we go back to the dotplot, on page six, you also see that some of the FOMC members have brought forward their first rate hike to 2022, where in the previous dot-plot, it was clearly 2023. But as I mentioned, I think at the beginning, if you look at these median target levels, so 2024 1.75%, 2023, 1%. That means that the normalization of monetary policy is extremely slow. So they will take a fairly long time before interest rates are back to levels that are close to what we call the neutral rate to not to go into that discussion.

And if you also add the fact that in any of these forecasts years, the forecast, the CPI forecast is above these levels, that means that you will have negative real yields for let's say, three more years, that is extremely long period. And in the normal conditions, risky assets, like equities, like negative yields, you get pushed out literally out of these lower yielding asset classes, especially if you take inflation into account. So, a negative real yield always means that the most logical way to go is higher up the risk curve, even if you don't want to. So I think that is the somewhat more dovish part of the latest FOMC statement. And again, Powell did I think a reasonably good job again, by splitting this tapering versus rate hikes. So he wants to have a gap between the two and also make clear that they won't immediately start hiking rates much faster than is now expected.

Erik: Okay, so where does this actually leave us in terms of bond yields. Are they too high or too low right now? What should we expect next?

Jeroen: Yeah, that is an interesting question. So we think as policy normalizes somewhat, and if inflation risk, of course are a little bit higher than the Fed now expects that because they are full on this transitory story. Yields are too low, but we also have to take into effect so we have a model estimate that takes a number of factors like unemployment and of course inflation but also the term premium into account. And if we produce that model now, it actually says that currently the US 10-year Treasury yield is 30 basis points too high and a big explanation for that is this term premium. The term premium is back to zero again, it's slightly negative, while on average, you would expect on normal conditions that this term premium had a difference between longer yields and shorter yields is positive, because you want to have some kind of premium for having the risk of inflation and growth in the future right? So this is how it normally should work.

Again, we believe that the uncertainty about growth and inflation are not low, especially on the inflation side. So there should be a positive term premium and as the Federal Reserve starts to wind down its bonds purchase, Wee also think that the term premium should tend towards its longer term efforts, maybe not immediately. And if you take into account that debt could normalize, then bond yields are too low. But I don't think that unless the supply chain disruptions make the inflation, headline inflation spike, again, from these levels, which are already elevated, that will be moving above 2% immediately. But yeah, the base case is up but gradually.

Erik: Jeroen, let's talk about China Evergrande, the property developer in China. It seems like maybe the accounting for this, I guess the largest property developer in the world was, you know, it's China, nobody's really paying attention. What happened here? What does it mean, some people are saying this is the Lehman moment that could bring about the next global financial crisis. How big of a deal is this, really and in particularly with respect to contagion?

Jeroen: Yeah, that of course, is the biggest question, because in itself, we should assume because it is very difficult to know exactly what is happening there. Not only because it's China, but also in the Lehman event that you mentioned, most people also didn't know exactly what was going on right? It is very complex but so it is about contagion because in itself, if the Chinese authorities want to end it, they can do that. They have ample room to do that. So I think the best thing is, indeed to look at indicators that reflect any potential contagion, because we don't know if Evergrande is going to pay the next outstanding coupon. They missed one, there's a grace period of 30 days. I think Sunday they have another one. It's very complicated. You have these authorities that say, you have to fix it, and then the company itself, you don't hear anything about it. So obviously, there is something wrong there but we don't know exactly what.

So a couple of things that we could look at and the first is on page three. That is in China's debt market and here you see a chart showing the high yield spreads, that is the blue line, which has spiked massively. Two thirds of the China high yield index are property developers so there's a big concentration of real estate in that index. But if you look at the investment grade spread, which is the green line, it hardly moved. And in that index, property developers have a much lower weight. So from this angle, I would say, little contagion so far. Also, in the last couple of days, the Chinese central bank, the PBOC has added liquidity. And that also means that if you look at interbank rates, and it's also what we did during the Lehman period, they are well behaved. And this is exactly of course what the Chinese government wants by injecting liquidity. But we also see that interbank rates are still relatively low. Another, I think more global indicator to look at is the Chinese currency, which is on page four. We have seen a couple of times in the last, let's say, 5 to 10 years, that whenever the Chinese yuan started to depreciate quite significantly, and also quite swiftly, that a risk of sentiment entered the market.

Now we saw on the Monday that markets went down quite a lot, because of this whole, how much contagion will there be issue. It depreciated a little bit, roughly half a percent. But you can see on the chart on page four, after that it has made up for some of that depreciation, and it's very close to the strongest level in years. So also, from the currency perspective, it seems at least for now that these contagion risks are not that high or not that persistent yet. The last thing I think that also why it won't be a Lehman. So I don't think it will be a Lehman event because of the capacity of the Chinese government to fix it in a good or a bad way. But they can do something and perhaps nationalization would be one of the options. I also think that the odds of a very big contagion effects are limited because of what is happening in China themselves.

So if you look, a lot of companies, they have found, let's say, alternative ways of debt creation, because credit growth was restricted by the Chinese government, so they created all of these fund, or they put out loans to these funds. And the thing is that a lot of evergrande employees, they actually invested in those trust funds, that if you also looked at the retail sales, of course, also because of a partial lockdown, it was very low, I think the threshold for the Chinese government to have a very painful and messy default is not extremely high. So I also think that from that angle, protecting its own consumers and workers, that they will find a solution. That does not mean of course, that contagious risks are zero and we have seen last week. So I do think this is somewhat a binary effect. If this drags on for too long, it will, again, hit markets, but I don't think it will be a Lehman style impact.

Erik: Going back to page 11, you mentioned before that you really source this from all of the assets that exist in markets, I noticed you don't have the newfangled one, which is Bitcoin on here. What's your take on the role or non role of cryptocurrencies in professionally-managed portfolios?

Jeroen: Yes, excellent question. So, we looked at it and I think one thing we want to make clear is that we do acknowledge the potential of Bitcoin as some kind of digital gold. So maybe not exactly the same. But I can imagine that investors see the potential of Bitcoin in this way. So having said that, so that also means that it has some value, we can have a long discussion about monetary value, or intrinsic value, but yet a lot of asset classes have monetary value, art has monetary value and has no intrinsic value. So for me that is not that relevant. The thing is, though, so if he would take the current market cap of Bitcoin, it would have a weight of 0.5-0.6% in this portfolio. The thing is that immediately, you have to do some of the things in a multi-asset context a bit differently. So for example, because of this massive volatility, so a lot of Bitcoin proponents, they say, okay, it's great, because it has a correlation of zero with every other asset class and that in itself is not a bad thing. But because Bitcoin has a realized volatility of 100%, which is more than five times higher than equities, the next biggest riskiest assets, you get all of this risk into your portfolio.

So what we are thinking about, and this is something as you answer to. Insight has just started and we're also looking at it, but we do want to make clear is that if you add it. We can imagine that you add it, but you have to be very aware of the risk-return profile that brings and also that, for example, rebalancing your portfolio has to be done much more often than in this regular, let's say regular, but more traditional asset classes. So, I think the whole asset management industry, multi-asset industry, we have to think about, okay, how are we going to incorporate this without having it dominating all of the portfolio characteristic and I think that at this point is a challenge. So if you stick with half a percent, I think with with some very rigid monitoring, it could work out but if you want to add that because you're positive to 5%, then the whole risk-return trade off that you that you aim for by having a multi-asset portfolio, yeah, that goes out the window and I think that is an important aspect to take into account. Having said that, I do think that there is potential for Bitcoin as some kind of digital gold

Erik: Well Jeroen, I can't thank you enough for a terrific interview. Before I let you go tell us a little bit more about what you do at True Insights and how people could follow your work if they want to find out more.

Jeroen: Thanks. Yeah, so [True Insights] is an independent investment research platform which has been newly created and what we offer to investors around the globe, both retail and professional investors is to enable them to construct well diversified multi-asset portfolios like you see on slide 11. And so we have done a lot of the work for you so to say. I think it is pretty difficult to come up with a balanced portfolio, a well diversified portfolio and what kind of choices do you have to make, as I explained on this chart, and we look at the total market cap of investable asset classes.

The second is and that is what we talked about for most of the time is that our research that we provide enables investor to capitalize as we call it on market developments. So basically, we offer tactical asset allocation or asset class fuels as we call them to enhance your portfolio risk-return profile. So by tweaking these weights a little bit, we won't go out of equities completely, of course, because we stick to this well diversified portfolio, but by adding to equities or reducing equities, and we want to increase the return also the risk-adjusted return, if you wanted in a technical phrase. And the way we do that, that is we offer three different memberships, which you can find on the website one that suits you. And basically after that, we do the work for these investors. And we hope of course, that they will use and can use our research to build these portfolios themselves and also to adjust them based on the current market developments and that is basically what the core of what we do.

Erik: Jeroen, I look forward to getting you back for an update in a few months. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.