MACRO Voices
with hedge fund manager Erik Townsend

Juliette Declercq: A Red String of Fate Ties U.S. to China
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Erik: Joining me now is Juliette Declercq founder of JDI Research a boutique institutional advisory service that advises some of today's most successful portfolio managers.

Juliet we originally had you scheduled for an interview a couple of weeks ago, in advance of that you sent us a sample research note in which you expressed a bearish view on the U.S. dollar index, a bullish view on U.S. 10-year treasuries which at the time were yielding two spot sixty and a rather outspoken opinion that the upcoming FOMC meeting – which of course had not happened yet at that point – would not produce a hawkish surprise as a lot of people were thinking.

Now quite frankly Juliette I was long dollar index futures on the day that I received that note and I honestly, I looked at one on two spot eighty something and rising rapidly when I received your note and I thought, what the heck is this lady talking about.

Well of course you nailed all three of those calls perfectly. I wound up being stomped out of that trade at a ninety-eight handle. So, I wish I had followed your advice a bit sooner. But you actually, instead of coming into that interview gloating. You asked us to reschedule the interview because at that point after the FOMC meeting happened, you felt like, OK, it's no longer actionable. You wanted to give our listeners something actionable.

So, we shuffled the schedule a little bit and we've brought you back now when you were able to give us a new research note. So, I'd love to hear a little bit about how you got all those calls right.

But let's move on to your more recent work obviously out of respect for your paying subscribers we can't share fresh research with our audience but you were kind enough to share with us a research note from about ten days ago titled Red String of Fate Ties U.S. to China which you penned back on March 27th and which our listeners can find a link to in their research roundup email, if you're not registered yet just look for instructions on how to get registered next to Juliette's picture on our website.

You recommended adding to the 10-year long that you opened at two spot sixty at that point the 10-year was down to two spots forty-five, today it's around two spot thirty-three.

So, you're just mailing all of these calls. Why don't we start with the additional charts that you sent us which we've packaged in a separate PDF that download link is also in the research roundup email and then get into this research notes, so take it away.

Juliette: Hey, so good afternoon, morning, evening everyone from sunny London. I invite you all to

read the particular report that Erik just mentioned and that my clients have agreed to share with you.

This time again the trades I recommended I've run a little faster than I could communicate it to you but the report is still very relevant and a good medium term trading roadmap.

The reference to China in the title is a wink to the fact that the U.S. economy cannot possibly be analyzed without taking into account the global outlook in the last two decades. Because my trade recommendations have now moved a lot in the right direction I'd like to hopefully offer some value to you by explaining the background of the way I'm thinking.

Firstly, I think it's important to remember that the US has not only invited but invented globalization and this is now at the roots of today's challenges. The current global taxes term in the U.S. which encourages tax evasion and which trump despises so much was in fact devised to colonize foreign workforces and bring down consumer inflation from the 80's.

You will see on the first chart called, Globalization the Good News, that this particular policy has worked wonders. The issue is that short term gains in the form of higher profits and lower consumer prices came at the price of long term pain for the average worker.

You will see on the second chart that the flip side of the globalization of the workforce, means that workers lost bargaining power and but wage shares as a percentage of gross domestic income collapsed whilst inequalities increased dramatically.

On the third chart, you can see that the initial consumer and cooperate gain quickly became worker pain and inequalities became more acute and GDP per capita has only recovered in real terms from the global financial crisis to early 2000s level but more importantly the median income which better describes average standard of living is very much lagging.

By now you've probably given up on getting a good trade idea from this call but I'm mentioning inequalities here because the implication for markets are enormous. To put things quite simply, the consumers' pain and resulting inequalities has now turned into cooperate pain.

In 2016 the IMF estimated that the middle class shrunk from about 58% of total in 1970 to 47% in 2014 with an astonishing 75% moving down the income ladder. The study also says that the rise in income polarization has decrease the level of real consumption at the aggregate level by a stunning 3.5%. This is basically more than a year of consumption.

Beyond shrinking demographics which we will all agree cannot easily be fixed, this is the real source of secular stagnation. Many look for example at the saving level thinking it's back to healthy levels but aggregate data hide the fact that almost half the population has negative savings. All this explains why I put an emphasis on aggregate demand leading growth but also the Feds thinking and this is nothing revolutionary.

In the 20th century Henry Ford had already sought to link product prices and employee wages so the latter became a natural market for the former. The issue today is that Henry Ford's concerns have long been forgotten and the one source of pent up demand left e.g. fixing inequalities remains vastly ignored.

Now to go back to markets, this explains why beyond the initial hope factor, I do not see Trump being able to fix the U.S. especially this late cycle. His focus on repealing Obama care and cutting taxes effectively is a further transfer from lower earners to cash risk corporates. Even with the best intention and flush with cash the lack of final demand means that corporates are likely to start investing and jumpstart an investment late cycle.

There is no prospect for more traditional aggregate demand growth ahead because the pent-up demand coming from employment growth is simply not there anymore and wage gains have been a long time coming. That means that a more astute solution for Trump would be to fill the lowest earners pockets.

Erik: Juliette, one of the first points that you make in the main piece “Red String of Fate Ties the U.S. to China” is you make the assertion that the FOMC outcome essentially validates and proves that your understanding of the Fed is correct. Now I'm very fascinated by this because you've definitely got the dollar and the Fed call spot on.

So, please explain this, help us understand what your view of the Fed is and how it relates to your core belief about economic growth potential.

Juliette: To answer your questions on how I consistently predict the Fed outcomes and I'd like to stress that I have no direct line to Lacker, the same way aggregate demand leads economic growth, it also leads Fed funds and you can see that on page three and four of my report.

It's less obvious this cycle due to the use of non-conventional tools to effect monetary policy but the Fed has actually followed exactly the same script and you can see that in some charts in my report.

Now I would compare the Fed's job to a sailing crew trying to stop a large sailing boat at a precise point. Any sailors amongst us will know that stopping on that precise point is probably as difficult if not more than travelling to this point. You have to take undercurrents into account, potential tailwinds, headwinds on the boat even in absence of a sail and etc.

This is exactly the same for the Fed even with the Fed's mandate seemingly in reach the FOMC has to take underlying micro-forces into account which are best described as aggregate demand growth.

Well demand growth is employment growth which will soon converge to population growth for the other 0.5% because for the simple reason that we are at full employment plus wage growth, which remains extremely subdued and a conundrum at this stage of the cycle and this is a medium-term growth potential, grim prospects.

So, even with the economy at full employment, upcoming headwinds are strong enough that the Fed despite an ambitious plan to get back to neutral has to stay cautious or run the risk of cancelling the budding business cycle.

With no real macroeconomic improvement, there was and there still is no room for the Fed to turn more hawkish especially given an already ambitious dots plot. Following the end Feb interview and yesterday's minutes, I would also like to attract your attention on the Fed hiking because equities are too high. I think it's a very dangerous game and I'll explain why.

Firstly, at the high end of the income a spectrum, a boost in equities may more than offset

higher rates but that the lower end those with debt will likely only feel the pain of higher rates. The issue is they are the most likely to drive the economy going forward.

Secondly equities can turn on the dime whilst monetary tightening can take months to feed through the lower demand and thirdly the leadership has changed only a few weeks after Trump's election and cyclical/value has consistently underperformed leaving equities stellar performance down to the equity risk premium compression. The risk is that if the Fed turns more hawkish with gloomy economic prospects, it flattens the curve and actually continues pumping up equities not because of promising earnings prospect.

In short, the Fed is reacting to worsening macro-conditions by tightening ultimately this is the perfect recipe for policy mistake. In short, the way I look at the Fed is by looking at what they have done in the past and what they should be doing and I try to ignore the noise and that's been really successful.

Erik: Now in the next section you move on to the business cycle and you pose the critical question of how long does Donald Trump have before it's too late. Please elaborate because a lot of our guests have suggested that this business cycle is very long in the tooth. So, how much longer can the euphoria last and what are the charts on page six telling us?

Juliette: In the section, you describe, I've modeled aggregate demand which is all monetary by adding the two sorts of money, basically incomes and the change in debt level. You can see on page six that this perfectly defines the business cycle and also the intermediate cycles.

What should normally happen on the strong ISM boost is that income growth picks up on higher employment or wage gains and credit demand should also pick up. This time the opposite is happening and this is telling me that the Trump trade is fantasy rather than the reality.

The reality is that there is no such thing as a Trump trade in 2016, there was no magic. The global economy reacted to the sharp easing in financial conditions stemming from the Fed's relent and China's vigorous stimulus like it has always done. Because of very strong price base it takes we had a bounce in activity for example energy sector cap ex collapsed 70% from 2014 to early 2016 and this subtracted0.7% from real GDP.

It's only natural that the bounce in prices necessarily causes the bounce in activity in 2016 from extremely low levels. The same goes for the distressed level of inventory. The issue is that none of those effects can be extrapolated into 2017 and the effect of the global stimulus has largely run its cause. In fact, base effects now work in reverse.

In short there is no such thing as a Trump trade although it is somewhat discounted by both markets and the Fed and I see this as a trading opportunity.

Erik: Juliette the bulls would tell us that the ISM is the near all-time highs and that signals nothing but rock solid growth and economic strength on the horizon, meanwhile another popular narrative is the president's Trumps tax and infrastructure spending initiatives will soon become reality and these factors can only be bullish for asset markets at least according to the bulls. You see it differently, so please explain why, why don't we start with the graph from pages nine and ten and what they're telling us and explain also where China fits into this story.

Juliette: So, on pages nine and ten you can see that investment does not in any way corroborate the bounce in ISM and we started to see signs of a peak in ISM this week with both a weaker manufacturing ISM and a much softer non-manufacturing report. The leading indicators defined by new orders versus inventory sentiment also look to have already turned the corner.

Basically, my fear is that the China driven early 2016 stimulus caused the debt cap bounce in global activity. Trump's campaign promises greatly and artificially amplified the position of survey effect as hard instincts took over and created the illusion of a more sustainable cycle.

I think we have already reached the top in terms of how far hope can support markets and I had recommended from the Trump's night to pay rates anticipating hope to run wild but reality is now about to hit.

The longer China growth can hold steady and the longer it will take for financial conditions to tighten more meaningfully but my best guess is that China growth can only be supported into the congress.

Erik: In the fourth section, you assert that the Fed isn't really as dovish now as it may appear but that it will likely be forced into more dovish-ness in the future. So please elaborate and why don't we reference the chart starting on page eighteen and maybe also talk about how this translates into trading strategies?

Juliette: OK, so and this goes back to my earlier comments as much as the Fed would like to think that the economy's in good shape and would like us to believe it, the tightening is happening despite break-evens being 40 base points below levels consistent with achieving the inflation target.

Income growth is showing no sign of life and there is supposedly no assumption of a fiscal stimulus, yet the dots return to neutral on a sustainable rise in the neutral real rate which is currently assumed to be around 25 base points.

As soft data start converging to hard data rather than the opposite, real yields will probably remain supported and the risk they offered. I'm not talking an abrupt selloff yet but of a protracted top in risk this means that dollar should stay off the Yen and that I'd look for opportunities to buy euros again. This also means that U.S. equities should be sold on spikes and that fixed income will eventually unwind all the Trump trade in a flattening manner.

Erik: Juliet I'd like to change the subject because although you are working in the city of London financial center I think it's pretty obvious from your accent our listeners have figured out that you are French.

French election, holy cow, you know this seems to be maybe after Brexit the next big milestone in where the future of Europe could be headed. So as a French person how do you see this, what do you think is likely to happen, what's at stake here?

Juliette: On the French elections, what I have been telling my clients is that I see quite a high potential for a last-minute twist and I will tell you why, firstly I haven't decided who I'm going to be voting for which is historically quite weird. Secondly, I think a little less than 50% of the French population is still undecided which historically again is weird two weeks

before the first run of the election.

I was looking at a poll this morning and asking firstly who do you think will win the election and 49% thought Macron will win the election but when the question was turned to who do you want to win the election, it was only 26%.

So, that we really strikes me as like basically everybody is just like going for Macron because in a way he's like the market perfect candidate. He's young, he's liberal. The problem is there's quite a lot of lack of idea behind him and he just seems to kind of agree with everyone. I don't feel this is the candidate that the French will really want to vote for right now.

So, that's one thing, high level of uncertainty and the second thing is that you've had basically the whole socialist party rallying behind Macron and basically leaving Hamon who has been basically voted in as a socialist candidate by French people like basically polling now below 10% mostly because Melenchon is doing much better with strong charisma and etc.

But I think a last-minute twist could be for Hamon to basically rally into Melenchon's campaign and that could basically put Melenchon in the second round and potentially run against Le Pen. So, you'd end up with like a Melenchon-Le pen second round.

Of course, that is still quite a low probability because it would call the best of the socialist party in France but it's not really one that I would dismiss because it would make complete sense for Hamon to do it this, if it was just to make sure that the socialist that are still behind him can keep their seats in the election in June in the parliamentary reelection in June.

So, I think there's still a lot of potential for last minute twists and I would absolutely not assume that it is going to be plain sailing.

Erik: Well Juliette, I know that you have an extremely busy schedule supporting your institutional clients so I'm not going to take too much more of your time but before we close most of the boutique advisories who operate the way you do, advising portfolio managers directly work on a fixed system where everybody pays a very large annual fee of tens of thousands of dollars per year.

But I think that you actually price your services tailored to the needs of each client and it is even possible for very well off retail investors, high net worth retail investors, to afford a version of your service.

So, please tell our listeners what is the nature of the services that you offer, who does it appeal to and who should contact you with respect to the advisory services that you offer.

Juliette: Basically, I've tried to democratize research offering by pricing pay a portfolio manager so that means that the idea behind my service was to try and offer the service of a strategist to macro-startups and so from smaller firms to much bigger firms and by pricing pay a portfolio manager that means by design a smaller company will pay a lot less than a bigger one.

I've got two different services, one includes basically all reports that I publish in a year and

that's about like three reports per month which should be giving you really good roadmap to trade markets and the second service is the premium service which is pretty much closed but I could have a couple new clients and where I am basically available daily on all big data, big events with trade ideas. This is the way JDI Research is functioning.

Erik: Fantastic, well I do want to caution our retail audience that this is not a $99 a year service so please don't waste Juliette's time but for our higher net worth individuals and certainly for institutions I think that the way you've democratized things does put your research in reach to people that probably wouldn't be able to afford the style of research elsewhere and I have to tell you I'm just profoundly impressed with the work that you do and the reports that you've sent us.

So, thank you so much for a fantastic interview. Patrick Ceresna and I will be back as Macro Voices continues right here at macrovoices.com.

[End of interview]