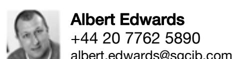
Global Strategy Weekly

A GDP slump might be ignored, but a slide into deflation will shock investors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While economists are spending a lot of time on the likely depth of the economic downturn and shape of the recovery, little attention is being paid to the recent decline in US CPI inflation data. Falling core CPIs are likely to be much more of a shock to investors than slumping real economy data - which is being largely dismissed. Although we believe we are transitioning from The Ice Age to The Great Melt, in the interim The Great Melt-*Down* is likely to reassert itself as the dominant near-term investment theme.

- Reams of commentary have been written about the likely depth of the global economic downturn and the shape of the recovery. Seriously heavyweight forecasters, such as the OECD and IMF, have applied much thought to this. While these supra-national organisations always seem to err on the side of optimism, the depth of the downturn *even* these perennial optimists forecast is quite shocking (see for example the OECD estimates below).

- It goes without saying that the depth of the downturn depends inter alia on how quickly the authorities can bend the pandemic curves with the current lockdown, how quickly they re-open their economies, and whether another flare-up of the virus necessitates further lockdown measures. It would be fair to say that investors are now somewhat more optimistic than they were, not least because of the extreme largesse of monetary and fiscal policy.

- Despite the improvement in mood in the equity market because of the *"whatever it takes"* policy headlines, perhaps all we have witnessed is a typical technical rally from extremely oversold levels. If this is so, with some commentators having already flipped and called the equity bottom, any relapse to a new low will decidedly sour the mood.

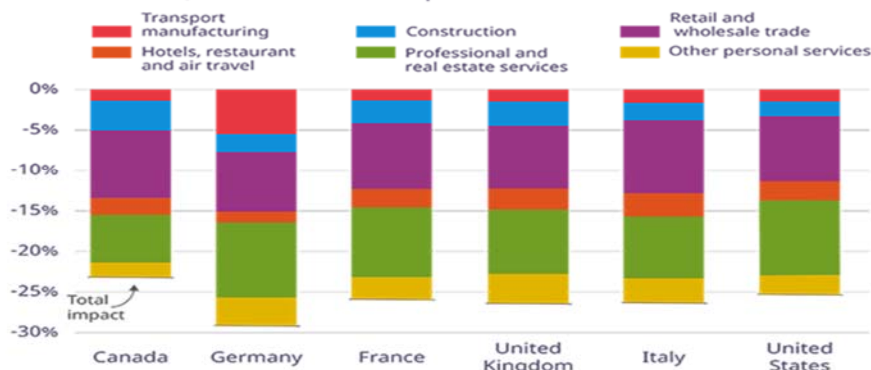
- If as seems entirely plausible to me, the equity market renews its slump, how long will we have to wait before the Fed starts buying S&P ETFs to add to its newly acquired 'junk' ETF collection? A decline in the S&P below 2190, the intraday 23 March low, will likely get the Fed twitching anxiously, **and if it falls 40% from its 19 February 3390 peak to around 2,000, I would expect to see the Fed step in and start buying equities!** For many that will certainly mark the bottom and the market will likely surge again. That may not be the end of this equity bear market though - after all the BoJ buying Nikkei ETFs hasn't worked so well, has it?

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

How deep is this economic slump likely to be? Very deep is the answer from the OECD



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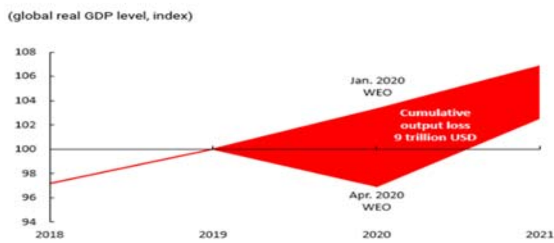
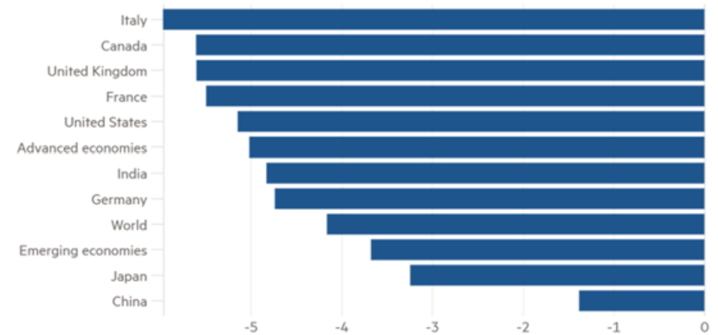
Amid all the pages of research I have read about the depth of the current economic slump and the likely shape of the recovery, the chart that stood out to me was the right-hand one below calculated by the fine folks at the FT using the new IMF forecasts (see chart below). This highlights that despite the V-shaped growth rate forecasts, even with the IMF expecting a 6% rebound in world GDP growth next year after a decline of 3% this year, world GDP will remain well below where it would otherwise have been by the end of next year (see left-hand chart). The largest western economies will see 5-6% economic scars even by the end of 2021.



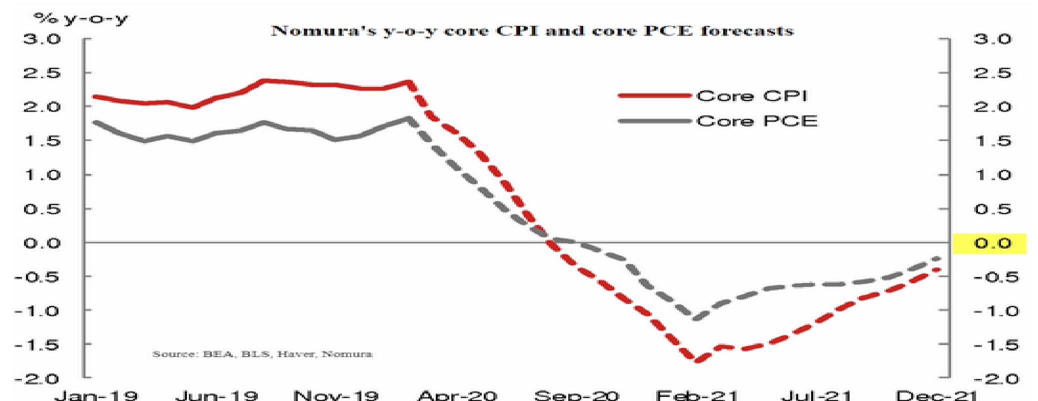


Source: IMF and Financial Times

An assessment of the near-term depth of the economic slump and shape of the subsequent recovery is absolutely crucial to investors in finding a floor for risk assets. To a certain extent, though, the market has written off the Q2 real economy data and can turn a temporary blind eye to it, however bad it is. The problem will come if any Q3 rebound is weak – perhaps adversely affected by corporate bankruptcies and a more persistent retrenchment of consumer spending and confidence. After that the market will need to assess any additional economic damage from a possible winter flare-up in the Covid-19 virus.

While I have seen much written about the above I have seen very little written about the likely imminent slump of the major western economies into outright deflation. Always just one recession away from outright deflation, many economic writers are instead concentrating on the medium and long-term inflationary impact from central banks crossing of the Rubicon into outright money printing. And although we would agree with those who believe we are transitioning into a world of rapid inflation in a phase we have dubbed *The Great Melt,* investors are ignoring the likely imminent deflationary bust unfolding in front of their eyes. We once again carry last week's chart showing how the fine folks at Nomura see the US core inflation outlook.

As we move through this year, investors are going to wake up to the reality of deflation

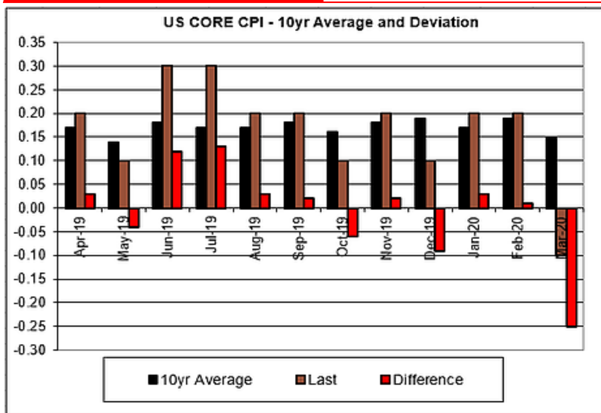


Source: The Daily Shot, Nomura

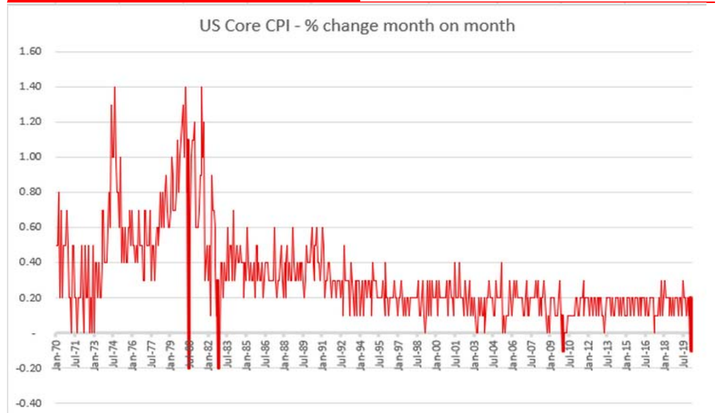
One specialist on 'all things inflation' worth following is my former Dresdner Kleinwort colleague Edward Ballsdon, who recently began putting his thoughts into a regular blog – The Grey Fire Horse. He notes that the latest US CPI outturn for March was shockingly weak, not because of the 0.4% mom decline in headline inflation, but because of the 0.1% fall in core CPI (ex food and energy). Now, minus 0.1% might not sound like much of a decline but as Edward explains, ***"The month on month (mom) change in the core inflation rate is one of the most stable reported economic series in the USA.*** *As a rule of thumb, the monthly inflation rate tends to fluctuate between 0.15% and 0.2% each month.*

"This stability can be seen by the BLACK columns in the (left-hand) chart below, which show the average mom inflation rate for the last 10 years for any particular month. The BROWN columns show the data releases for the last 12 months, and the RED shows the difference between the last reading and the 10-year average for that particular month.

The latest US core CPI data was shockingly weak



This is only the second time core CPI has gone negative since 1983

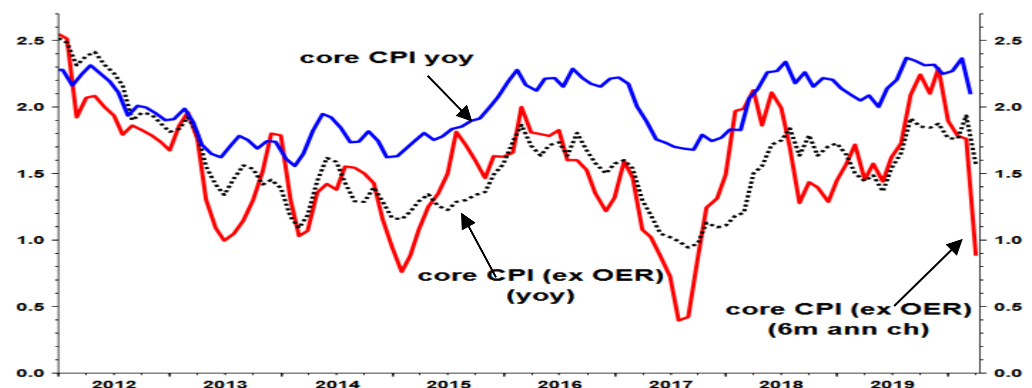


Source: The Grey Horse Blog

Ed continues *"I have been updating this (left-hand) chart for 20 odd years. A series of negative (positive) red bars quickly identifies disinflationary (inflationary) periods, which warns of changes to Fed Monetary Policy. What is very unusual in the above chart is not that the red bar is negative,* ***it's that the brown bar is negative.*** *This is a very unusual occurrence due to the way CPI is constructed (predominantly due to the large 'shelter' weighting, but that's another story). How unusual?* ***The chart (above right) shows the monthly core mom changes going back to 1970. It has been negative only five times in the last 50 years, and only twice since inflation was tamed by Paul Volcker."***

Another way to see just how weak the March core CPI data was is to look at core CPI ex-owner equivalent rent (OER is some 25% of US CPI but it is not included in eurozone measures). OER inflation follows actual rent and has been running above 3% for some time (rent inflation is likely to slow sharply soon). But the sub-1% latest reading in the red line below is worth watching.

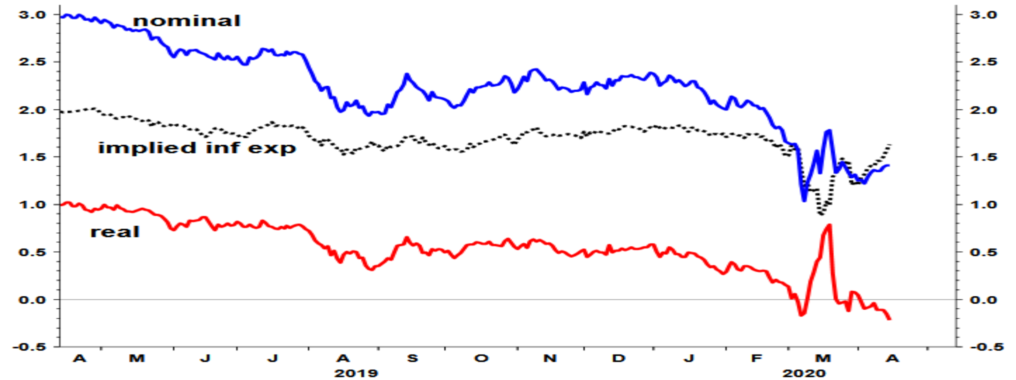
Core US CPI is slowing sharply, especially when Owner Equivalent Rent is excluded (yoy, 6m% ch)



Source: Datastream

Regular readers know that I have long warned that the next recession would bring about either outright deflation in core CPIs, both in the US and the eurozone, or at least *the fear* of outright deflation. Well the "next recession" is here. And despite implied inflation expectations surging recently, in line with the equity rally, I think the black dotted line in the chart below is going to turn sharply lower again and probably soon fall well below zero.

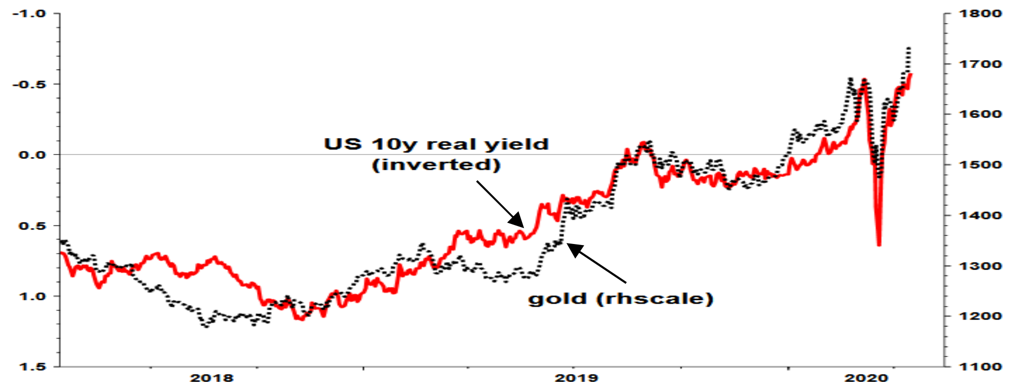
US 10y implied inflation expectations have surged recently



Source: Datastream

If (when) inflation expectations collapse I do not expect that real and nominal yields will surge again in the way they did in mid-March for one turbulent week when liquidity issues arose (see chart above). Instead I think the period up until March 9 where both inflation expectations and real/nominal yields all fell together will be repeated. That would be good news for gold investors who saw prices briefly crushed in mid-March as real yields briefly soared (see below).

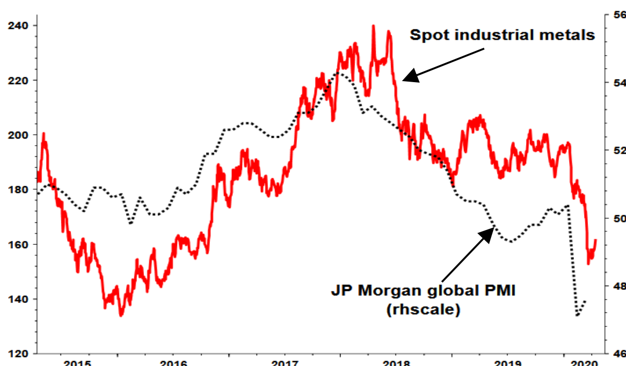
The gold price seems to be tracking the real yield closely



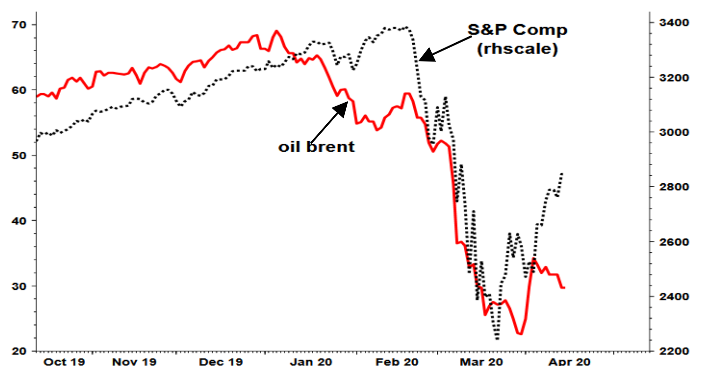
Source: Datastream

While on the subject of commodities, we are watching them closely as a real time indicator of real economy developments (see chart below). Also, is oil leading stocks lower? Maybe.

Industrial commodities and global manufacturing PMI



Are oil prices leading the equity market?

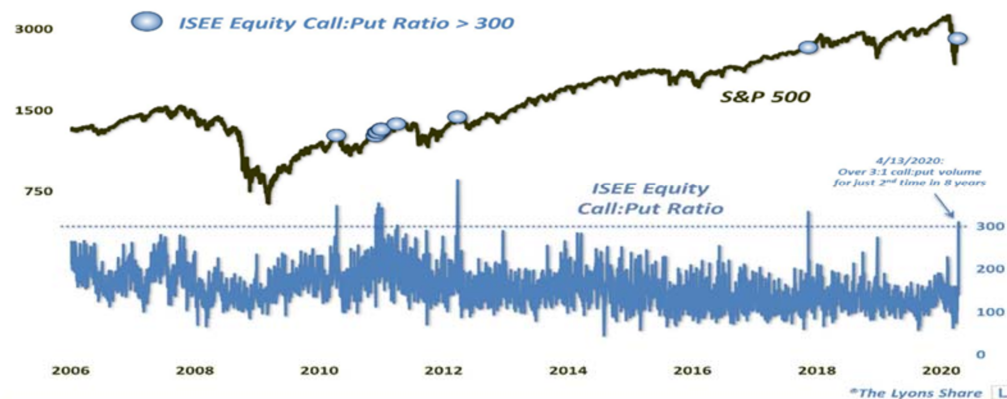


Source: Datastream

Financial markets ebb and flow within a long-term up- or downtrend depending on many things, and the fundamentals are just one of them. Often markets rally strongly within a bear market for purely technical reasons. But newspaper columns and broker reports have to be written – and just suggesting the recent strong equity market rally is merely a 50% retracement of the sharp decline to over-sold levels is not going to grip readers. They would rather hear that the bear market is over and that the rally is being driven by aggressive Fed action.

We are eclectic in our analysis in that we try and incorporate both fundamental and technical analysis. I have mentioned some of my favourites previously, but this chart on Twitter from the excellent Dana Lyons @JLyonsFundMgmt caught my eye. It shows an excess of option calls over puts – suggesting the market is excessively bullish on a near-term technical basis.

When Option calls exceed Puts the market is vulnerable to a downturn

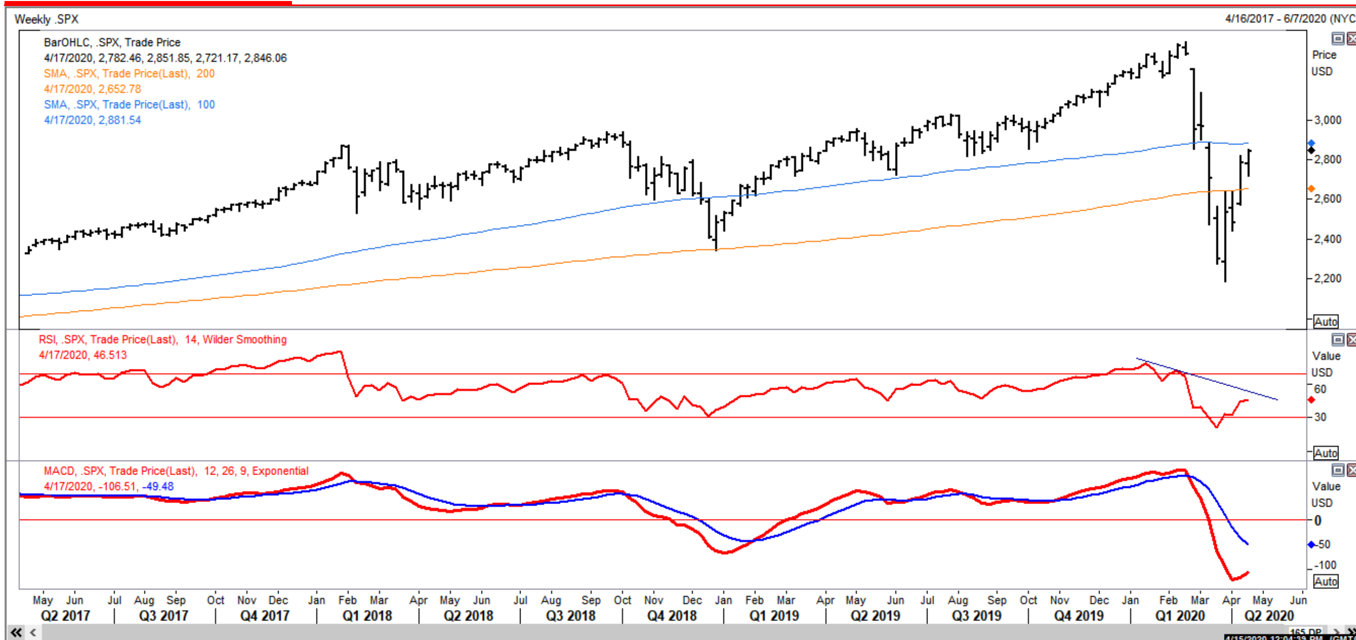


Source: Dana Lyons @JLyonsFundMgmt

Having recovered half the sharp decline from the peak, a failure of the recent S&P rally at the 100-week mav seems a distinct possibility (see chart below, personally I was surprised when it crashed below the 200w mav so easily). We also note that the weekly RSI (middle panel) and MACD oscillators (bottom panel) are still in a downtrend.

One thing I do feel confident of though: if the market breaks below the 2190 March 23 low and begins to head towards 2000 (a 40%+ decline from the high), don't be surprised when the Fed announces it will begin buying S&P500 ETFs. It is indeed a mad new world!

The 100-week moving average (blue line top panel) might prove a hard hurdle for the S&P rally to overcome



Source: Thomson Reuters Eikon

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