Global Strategy Weekly

The US has fallen into the deflationary abyss ahead of the eurozone

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Clearly investors can ignore many things, including collapsing GDP and profits on hopes of a V-shaped recovery and a return to normality. But one thing the market will find far more difficult to ignore is that for all the fiscal and monetary largesse, the US economy has already slipped into outright deflation. And this will not go away anytime soon.

- We are transitioning from The Ice Age to The Great Melt. Massive monetary stimulus is combining with frenzied fiscal pump-priming in an attempt to paper over the current slump.

- Since the start of my working career in financial markets in 1982, inflation and bond yields in developed economies have enjoyed a one-way disinflationary slide. It has not been all plain sailing however. My Ice Age thesis explained how a tipping point would be reached where western financial markets would mirror what we saw in Japan during the 1990s and beyond. A gravitational pull towards outright deflation (exacerbated by policy mistakes) would cause a re-rating of stability in absolute and relative terms compared to cyclicality. Despite the equity market powering higher in recent years these Ice Age themes have still served investors well - as bond proxies within the equity market have massively re-rated relative to cyclicals.

- I believe we are now in a transition phase as The Ice Age begins to thaw. This economic bust is so serious and so deflationary that policymakers felt they had no choice but to cross the policy Rubicon. In The Great Melt there will never be any serious attempt to reverse policy stimulus. Indeed we will see more and more stimulus until the deflationary ice melts.

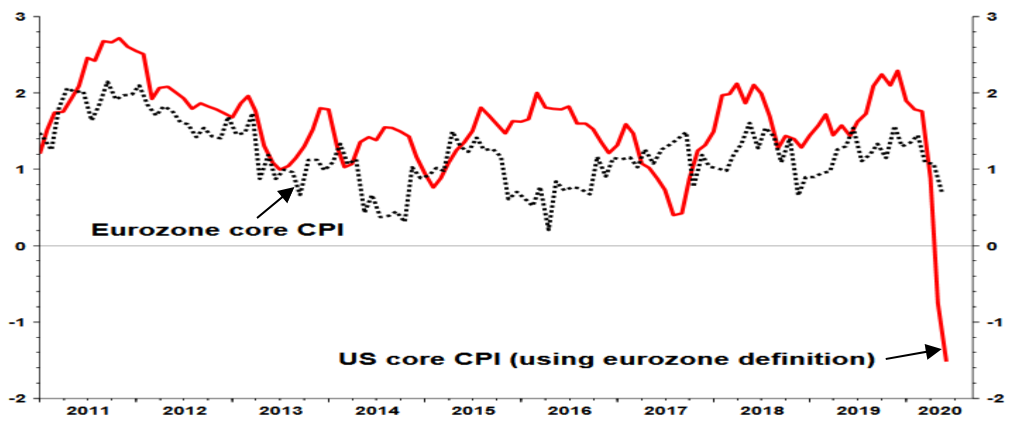
- But in the interim, before The Great Melt gains proper real economy and inflationary traction, we need to fully embrace *The Great Melt-Down* – the final stage of the Ice Age. And although I too have become a believer that inflation will be properly re-ignited in the next economic cycle, the markets are too focused on what lies ahead and not on the deflationary crevasse that has just opened up beneath them. Yesterday's May US CPI data saw an unprecedented three consecutive mom declines in core CPI. Previously even a single sighting of a 0.1% mom decline in core CPI was as rare as hen's teeth. Before this year there were only three mom declines since inflation peaked in 1982! US core CPI has now slumped into deflation and the markets will find this a most difficult crevasse to bridge.

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

Measuring US inflation in the same way as the eurozone (ie excluding Owner Equivalent Rent), US 6m annual change in core CPI has slumped into deep deflation



Source: Datastream

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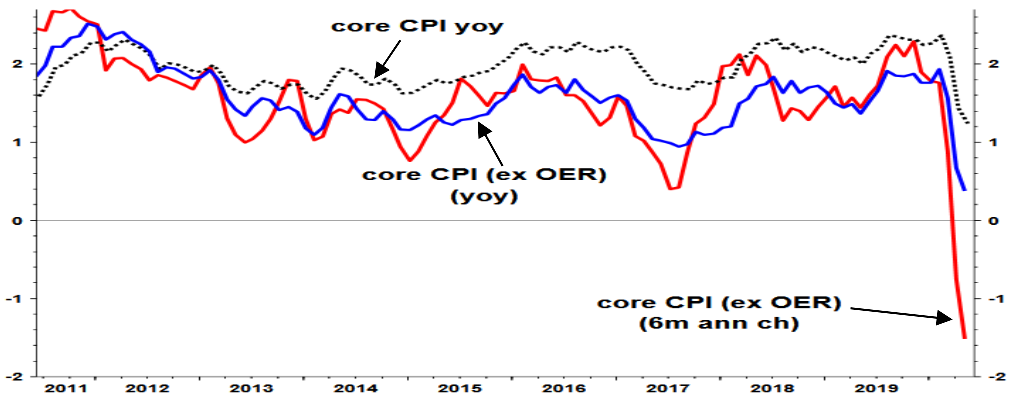
In May, US core CPI (ie ex food and energy) continued its unprecedented slide with the yoy inflation rate slowing to 1.2%, half the rate seen as recently as February. But excluding imputed Owner Equivalent Rent (OER is not included in the eurozone measure) – this comparable measure is rising only 0.4% yoy and falling sharply on a 6m basis.

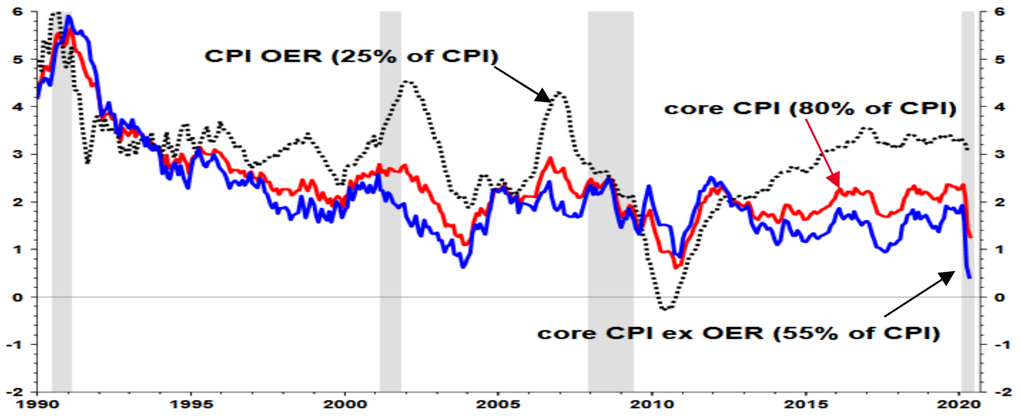
US core CPI inflation ex OER has collapsed (red line below is same as on the front page)



Source: Datastream

A longer run chart shows how high OER inflation (which tends to mirror actual rent inflation) has held up core CPI. The rapidity of the slump in the core inflation ex OER is shocking and we have discussed the likely temporary nature of high OER/rent inflation on core CPI previously.

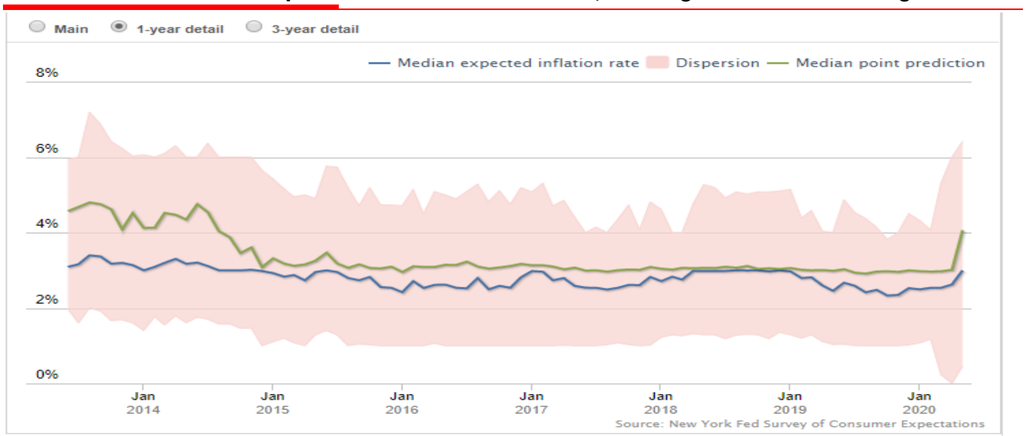
The depth of the current deflationary abyss is disguised by inflation in OER (all yoy % ch)



Source: Datastream

Despite this weak data, surveys show people believe inflation is set to rise (see below). It is notable though that the uncertain outlook is reflected in a sharply wider dispersion of forecasts.

NY Fed shows a wider dispersion of inflation forecasts, with higher inflation winning out



Source: NY Fed May 2020 Survey of Consumer Expectations

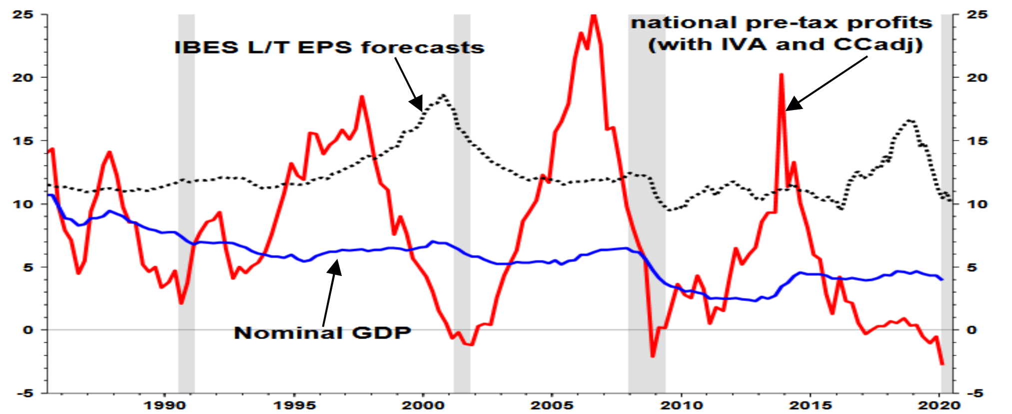
In the same way that bond yield forecasts tend to always call for higher yields, the market is consistently surprised that the US inflation outturn undershoots expectations (chart below). Hence it is curious that investors have not absorbed the current deflationary reality.

Inflation expectations have declined to be more in line with core inflation, just as it is slumping

Source: WSJ, The Daily Shot, Oxford Economics

The slump in inflation feeds into the core of my Ice Age thesis and concerns equities too. Nominal GDP growth will slow further (blue line in chart below) and drag down analyst forecasts of long-term eps growth, which are already weighed down by the ongoing profits collapse.

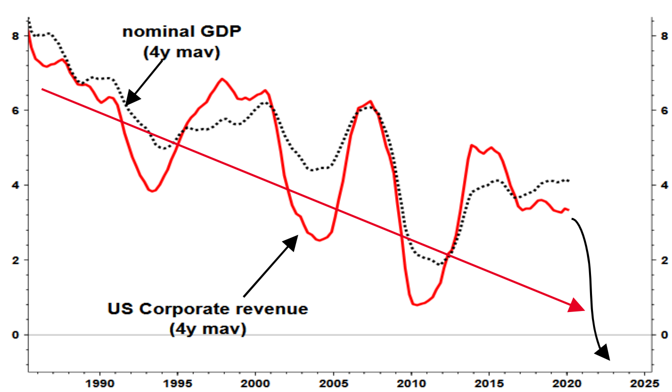
L/T eps forecasts being undermined by current profits and nominal GDP recession (5y % ch)



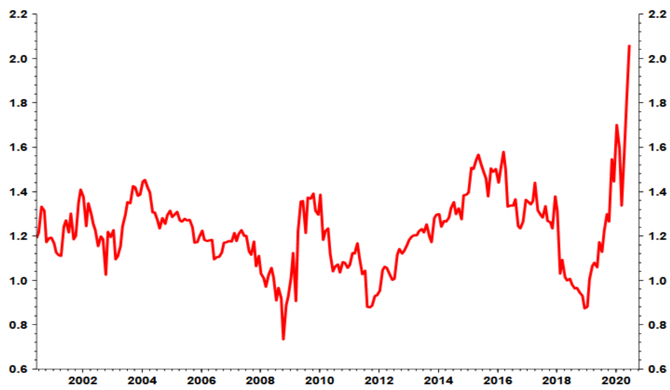
Source: Datastream

The slump in core CPI is bringing the Japanification of US nominal growth (see left-hand chart below) to an economy already heaving with debt. As this will trigger a further decline in L/T eps, nose-bleed expensive PEG ratios will likely be fatally undermined. Before markets can properly embrace The Great Melt, they first need to comprehend the new normal: deflation has arrived.

Corporate revenue (GVA) growth and nominal GDP



S&P PEG ratio (18m forward PE/long term eps growth ratio)



Source: Datastream

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