The global growth scare is a false alarm

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The global growth scare this summer is a strange animal. The plunge in US Treasury yields hints at economic recession, or at least a relapse into 'secular stagnation' as far as the eye can see.

We are back to the Japanification syndrome: $14 trillion of safe-haven bonds are again trading at negative yields worldwide. This includes German debt out to a maturity of 20 years, at a time when German inflation is reaching levels not seen since Reunification in the early 1990s.

At the other extreme, the junk bond market is euphoric. Funds are happily mopping up the weakest CCC-rated corporate debt in the US as if there was no tomorrow, compressing risk spreads to levels that surpass the giddiest days of the pre-Lehman

debt bubble. The spread on BBB-rated debt has fallen to a record 1.11pc.

Meanwhile, Bank of America says the trailing price-to-earnings ratio for the S&P 500 index on Wall Street is also at an all-time high of 29.8, topping the dotcom peak in 1999.
The 50-point drop in the benchmark 10-year US yield since early April – touching 1.25pc last Thursday – can hardly be ignored but it also defies easy explanation. RBC Capital said people are "just grasping at a hodgepodge of reasons" that fail to convince, such as the delta variant.

Michael Darda from MKM Partners says this is nothing like earlier "risk-off" episodes when falling Treasury yields were linked to stress in the credit markets and to a collapse in prices for base metals. This time the Bloomberg commodity index is still close to a six-year high.

Investors are comfortable with the current glaring contradiction in the markets, since it permits a profitable continuation of the Goldilocks trade that has prevailed on and off since the global financial crisis. Slowing growth means QE stimulus for longer. All assets rise together.

Yet Mr Market has been a little too quick to downplay the scale of the US reflation triptych: a Rooseveltian $3 trillion budget deficit equal to 13.4pc of GDP this year (CBO data); core inflation at a 29-year high of 3.8pc; and a 32pc rise in the total M2 money supply since the onset of the pandemic.

I stick to my view that the combined effects of Covid-19, the shock of Trumpian mobs, and Western technological rearmament against China have fundamentally changed the economic landscape, opening the door irreversibly to fiscal expansion. This has until now been accommodated by loose money from central banks, which have switched from inflation targeting to fighting inequality (and climate change).

The Goldilocks template no longer holds. The chief risk to equities over the next few months is not a global growth scare but the polar opposite: a pervasive rise in prices that proves anything but 'transitory', forcing the US Federal Reserve and its peers to hit the brakes sooner and harder than investors expect.
The Fed's regional presidents are already grumbling about the ultra-dovish Board in Washington, questioning why the institution is still trying to hold down yields with $120bn of bond purchases each month when the US housing market is on fire. The National Association of Realtors says the median price of existing homes is rising at a record pace of 24pc, more than twice the subprime peak, *nota bene*.

"We can't have a boom and bust cycle in something like real estate," said the Boston Fed's Eric Rosengren. Robert Kaplan from the Dallas Fed said it was time to start tapering QE before this gets out of control, if it isn't already dangerously late.

There is an unsettling technical explanation for the perverse behaviour of the bond markets over recent weeks that should give pause for thought. A temporary surge in central bank liquidity for technical reasons has overwhelmed the normal signals. Crucially, the US Treasury is running down its enormous TGA account held at the Fed in order to cover the Biden spending plan.

This has injected an extra $850bn into the financial system since late February, which is in turn flooding into commercial bank reserves and acting as a form of super-charged QE. Matt King from Citigroup says it has tripled the short-term impact of Fed bond purchases and led to a scarcity of Treasuries.

This distortion is not going to last beyond the late summer. At that point the Biden administration will have to find real buyers in the open market to cover its deficits. Foreign funds may baulk at steeply negative real rates and demand a premium closer to 2pc for 10-year bonds.

Chetan Ahya from Morgan Stanley says the growth scare explanation for falling Treasury yields does not bear scrutiny. It resembles the false alarm a year ago when investors feared that a second wave of the pandemic would abort the fragile recovery. Instead Treasury yields rose 120 points over the next eight months as America recovered faster than most thought possible. The relapse story is no more plausible this time.

Vaccination has broken the back of Covid-19 in the rich OECD countries and, arguably, in China. Europe and America are not going to shut down their economies again whatever the delta variant may bring.
Latin America has already been through the eye of the storm. There are major outbreaks across Southeast Asia but the aggregate effects scarcely move the global macroeconomic needle at this stage. Every country, bar the handful of zero-Covid hold-outs, has learned to live with the virus at manageable levels of economic friction.

You can make a case that the sugar rush of US fiscal largesse is already fading. The Hutchins Center on Fiscal and Monetary Policy in Washington says its fiscal impact gauge turned negative in the second quarter and is pointing to “several quarters of restraint”.

But this is not a normal situation. The earlier stimulus was in the form of emergency transfers to families during the pandemic, which was then partly bottled up by lockdowns. Morgan Stanley says they are sitting on $2.3 trillion of excess savings, waiting to be spent. Yes, the US budget deficit will be down to 4pc by next year but this is a mechanical effect of the boom itself rather than a return to austerity.

Corporations are also sitting on piles of cash, and inventories are critically low. The ratio of stock to sales in the US car industry is two-thirds below normal levels at just 0.8, and has never been anywhere close to this in over half a century of modern data. Morgan Stanley says the world is on the cusp of a red hot boom in capex investment.

It is true that the US economy often slows sharply, and recession risk rises, once the point of peak growth has passed. The Atlanta Fed’s instant GDP tracker has fallen over the last three months (from a pace of 13.5pc to 8pc). But on this occasion it is partly caused by the bottleneck effects of reopening.

What is unique today is the mix of excess savings, pent-up demand, and the inventory cycle. “We think it’s incredibly difficult to make the case that growth is going to slow in some pernicious way,” said Tom Porcelli from RBC.

The labour market 'tightness index' (NFIB data) is currently higher than at all previous peaks over the last 40 years. Unfilled job openings are at a record high of 9.2 million, and service wages are rising at a blistering rate of 5.4pc (six-month annualised).

The Powell Fed has created an exorbitant bar to monetary tightening by dwelling on the net six million jobs that have yet to return. But large numbers have cashed in their windfall wealth gains and taken early retirement. Others are holding back because furlough support remains until September, schools have been closed, and child care is expensive. The relevant indicator is that the prime working cohort aged 25-54 is almost back to pre-pandemic levels of employment already.

At the end of the day, it comes down to the quantity of money theory. Is it possible to increase the stock of M2 money by 32pc over 15 months - much of it latent and still unused - without setting off a surge in bank lending once the economy fully reopens?

James Ferguson from MacroStrategy says that over the last 70 years, deposits held by US households have never deviated from a narrow band between 47pc and 57pc of GDP. They currently hold deposits equal to 66pc. Is it credible to base policy on the assumption that people will squirrel away this money rather than spending a big chunk of it? No, it is not sociologically credible.

Will the velocity of money revert back towards its trend level over coming months, ignite the excess liquidity, and lead to inflation that is patently not 'transitory'? The evidence is that this process is already well underway and I therefore suspect that the Fed will find itself having to impose a minimum of discipline sooner than the market expects.

A taper tantrum is coming this autumn. Think of it as a cleansing purge. Only then will it be safe to buy the dip with conviction.