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THOUGHT CONTAGIONS

# Attack of the 15 Basis Point Deflation Monster

Tuesday, September 2, 2014

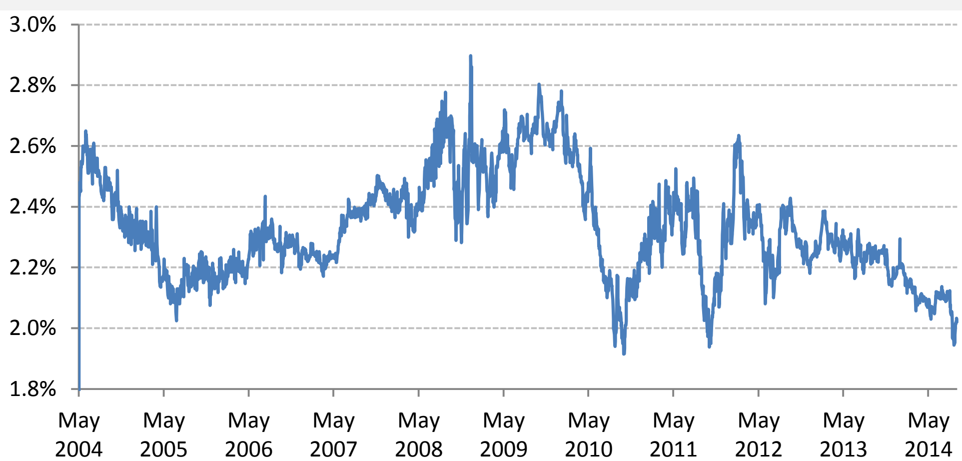
**Donald Luskin** with research input from **Lorcan Roche Kelly**

**A dubious deflation emergency in Europe isn't justification for such low US Treasury yields.**

The hot topic among clients has shifted 180 degrees in the space of just two weeks -- from widespread worries about inflationary overshoot to the exact opposite: the conviction that *deflation* is back, and that it is an incurable sickness of the global economy. Dropping bond yields worldwide will do that, along with ECB President Mario Draghi's off-script remarks at the US Federal Reserve's Jackson Hole conference, declaring what amounts to a deflation emergency in the euro area (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014).

- Inflation in the euro area -- actual and expected -- is low and has been falling, and that surely explains much of the drop in euro area sovereign yields to record lows.
- *But we think Draghi is exaggerating it to strong-arm his reluctant ECB colleagues to agree to some form of quantitative easing. In fact, we expect Draghi to commit to ABS purchases at Thursday's Governing Council meeting, but there will be few details given.*
- *Be that as it may, Draghi's* deflation emergency *doesn't necessarily say anything about US deflation. In fact, to the extent that the deflation narrative has dragged down US yields, we think that's an exploitable mistake that markets will have to correct.*

**Euro 5-year inflation swap rate, 5-years forward**




Source: Bloomberg, TrendMacro calculations

**Update to strategic view**

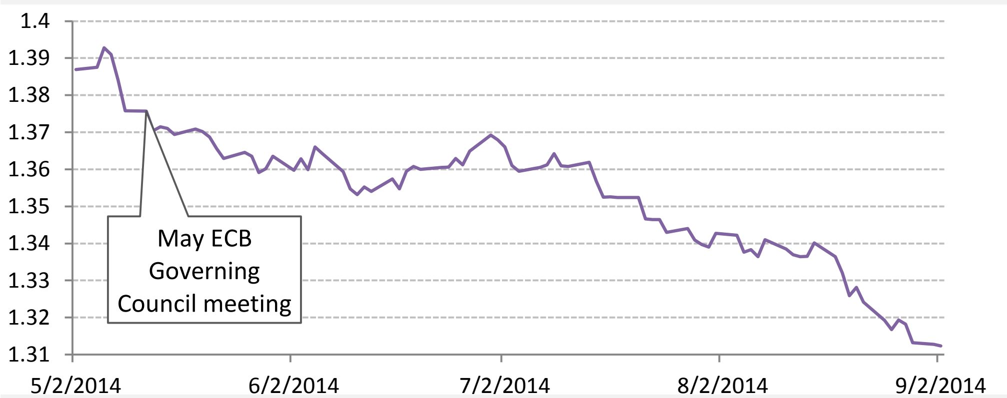
**US BONDS, US MACRO, US FED, ECB, EUROPE MACRO:** There is no deflation evident in the US, despite the euro area deflation emergency that Draghi has cooked up with dubious data. That will probably lead to a details-light announcement of ABS purchases at this week's ECB policy meeting. But to the extent that low long-term Treasury yields are implying a drop back to too-low US inflation, we believe they are wrong, and will have to be corrected. Treasuries have a poor track record as inflation predictors -- and from today's at-target inflation levels, we have a new Fed chair dedicated to intentionally overshooting, and about to get her most powerful policy tool back as the funds rate moves above the zero-bound.

[Strategy Dashboard home]

We'll get to US inflation/deflation and its consequences for Treasuries in moment. But let's start with Draghi's self-declared deflation emergency.

- At Jackson Hole, Draghi argued that long-term inflation expectations are becoming unanchored. He said, "The 5year/5year swap rate declined by 15 basis points to just below 2% -- this is the metric that we usually use for defining medium term inflation."
- *Really? 15 bp? That's an emergency?*
- Recent movements in the euro exchange rate completely contradict Draghi's claims about inflation expectations. Since the May 8 Governing Council meeting -- at which Draghi made it abundantly clear that major policy easing would be coming (see "Draghi Commits to QE" May 9, 2014) -- the euro has steadily weakened versus the dollar (please see the chart below). All else equal, a weakening currency is typically an indication of rising inflation expectations, not deflation expectations.

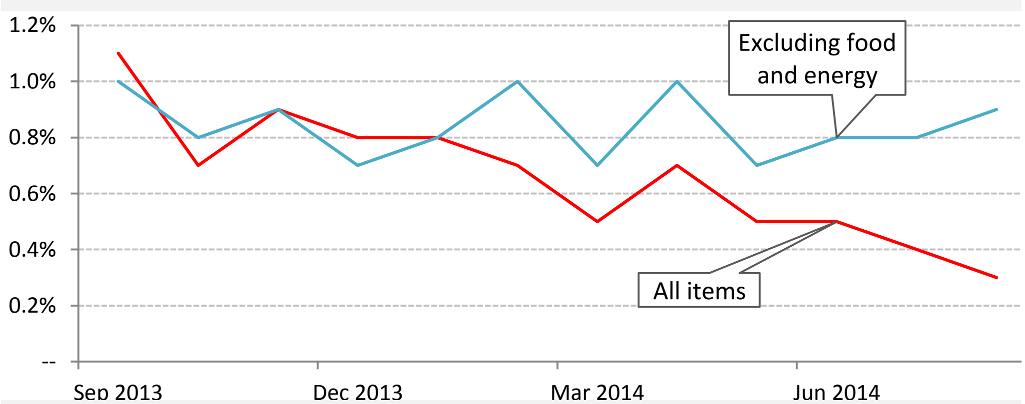
**Euro currency in US dollars**




Source: Bloomberg, TrendMacro calculations

- And actual reported euro area inflation statistics don't show a deflation emergency. Euro area inflation was reported on Friday at 0.3% year-over-year. But core inflation was reported at 0.9%, an uptick on the month, and pretty much stable over the last 12 months (please see the chart below).

**Euro area inflation** Harmonized consumer price index, YOY




Source: Eurostat, TrendMacro calculations

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[About us]

**Recommended Reading**

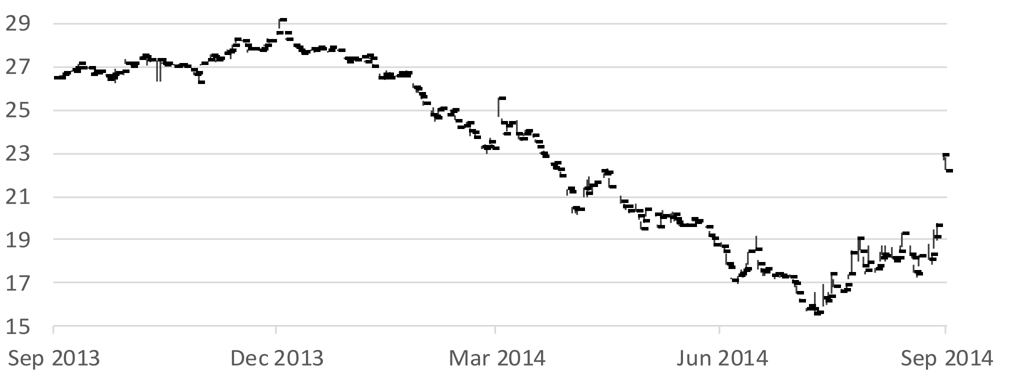
**Polanyi's Paradox and the Shape of Employment Growth**
David H. Autor
August 11, 2014

**Stock Returns over the FOMC Cycle**
Anna Cieslak, Adair Morse and Annette Vissing-Jorgensen
June 25, 2014

[Reading home]

- We note that energy prices in the euro area, which make up about 11% of the measured consumption basket, are off 2% year-over-year. Indeed, falling oil prices due to the technology-driven US supply revolution could continue to weigh on headline inflation (see "The Stench of CrISIS" June 25, 2014).
- But an inflammation of what Draghi called at Jackson Hole "Russia-Ukraine geopolitical risks" could reverse that decline in a heartbeat, if Europe were deprived of Russian natural gas. Thus, ironically, a source of deflation in Draghi's view is in fact an inflationary threat.
- Indeed, we note with some alarm that as Europe grudgingly considers new sanctions against Russia, Russian President Vladimir Putin shifts the diplomatic conversation to "statehood" for south-eastern Ukraine, and Ukraine enters a virtual state of war with Russia, natural gas prices in Germany have gapped up Monday to levels not seen for six months, since just after the Crimea crisis (please see the chart below).

**Natural gas at NetConnect Germany GmbH hub**
Front-month futures contract, EUR per mwh




Source: Bloomberg, TrendMacro calculations

- All that said, we admit that Draghi does have a point -- one that matters very much to the execution of forward-looking monetary policy. Euro area inflation has run below the ECB's target of 2% for 19 months now, and as Draghi puts it, if "low inflation were to last for a prolonged period of time the risk to price stability would increase."
- So Draghi may be right to turn his 15 bp into a *force majeure* -- if that's "whatever it takes" to get the balky ECB Governing Council to finally go along with QE, and if *that's* "whatever it takes" to keep long-term inflation expectations anchored.
- *But that doesn't make it true. Draghi's 15 bp doesn't mean there really is a deflation emergency.*

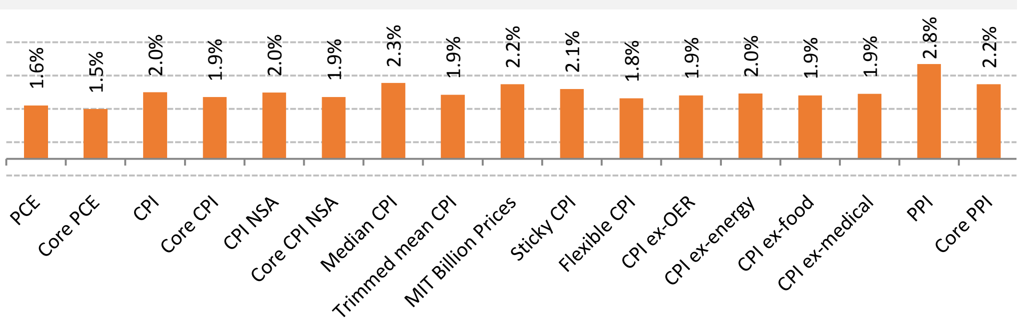
Which brings us to the US, and to the Treasury market. *Arguably, the steep drop in long-term Treasury yields this year -- happening at the same time as the drop in euro area sovereign yields -- is an indication of mounting deflationary expectations for the US, just as Draghi says he sees in the euro area. But we don't think that's what the Treasury market is telling us -- and if it is, we think it's wrong.*

- We're already on the record with our view on falling Treasury yields, and the flattening of the US yield curve.
- Our view is that it's due to what we've come to call "the Yellen Rule" -- the Fed's promise that policy rates will soon rise above the zero bound, but after that will be held permanently lower than normal for any given economic environment that may arise (see "The Yellen Rule is Taylor Minus Two" May 19, 2014).
- We think this view would be pretty bullet-proof as an explanatory theory except for one thing. *Treasury yields indeed give new Fed chair Janet Yellen full credence for delivering her promise of permanently below-normal but positive rates. But at the same time, yields seem to be assuming that Yellen's policy will fail to either sustain growth or inflation.*
- We resolve this paradox by granting that the bond market is pretty good at reading and understanding the 38 words that embody the Yellen rule, repeated now verbatim in the March, April, June and July FOMC statements (below, with the critical policy intention called out in red).

> **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

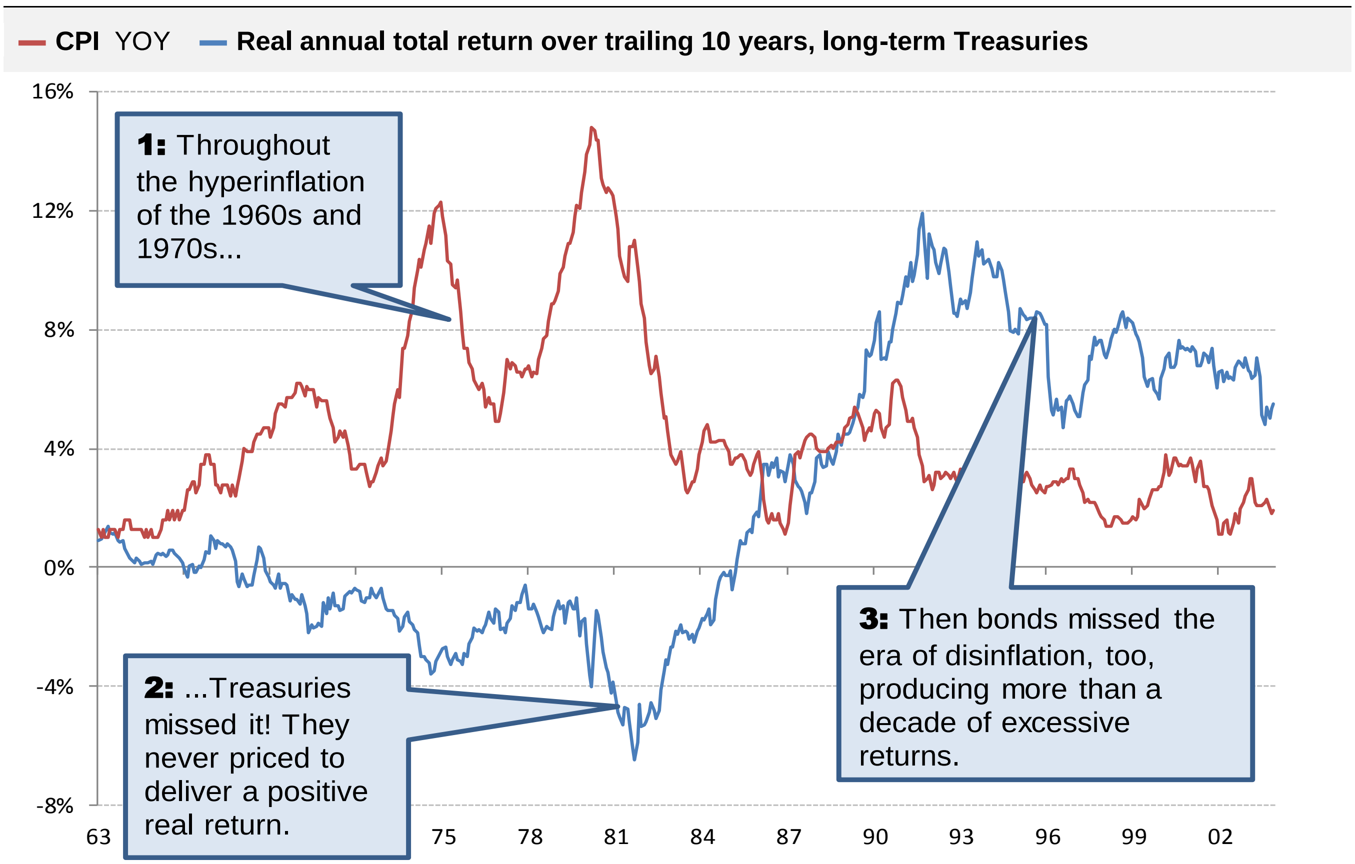
- With those words in mind, simple prediction-free bond math will move long-term yields somewhat lower and short-term yields somewhat higher -- just as we have seen.
- The bond market can do the math. *But the bond market is demonstrably poor at predicting future inflation. And the inflation prediction implied in bond yields today is nothing short of heroic.*
- First, consider the starting point against which an implicit deflation prediction is being made. *Monetary deflation is completely absent in the US inflation data.* By virtually all measures, conventional and unconventional (see "Data Insights: CPI/PPI" and "Data Insights: Unconventional CPI" August 19, 2014), the US inflation data is at, a little above, or a little below the Fed's 2% target -- and has generally been rising (please see the chart below).

**US inflation data** As of July, 2014, YOY



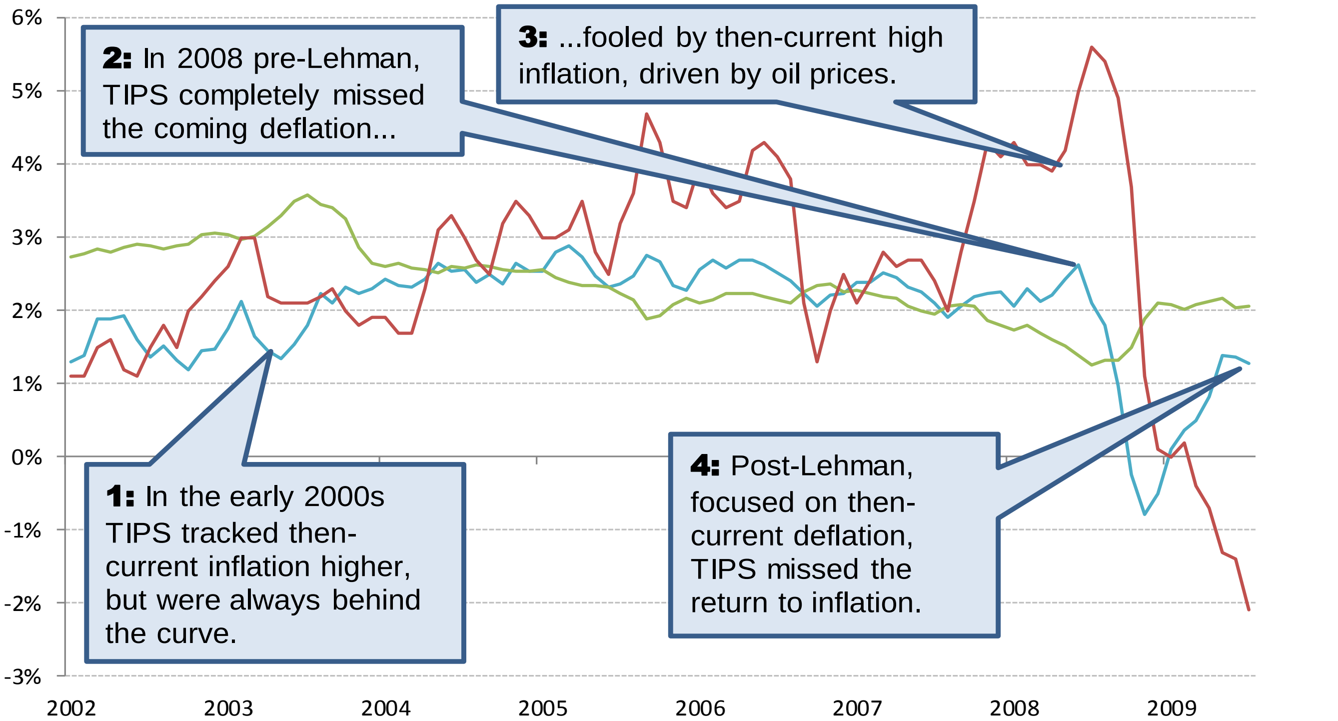

Source: BEA, BLS, Various, TrendMacro calculations

- The Fed acknowledged this at the July FOMC when it noted, "Inflation has moved somewhat closer to the Committee's longer-run objective" (see "On the July FOMC" July 30, 2014). The Fed went on to note that the risk of deflation was receding, not increasing, saying "…the likelihood of inflation running persistently below 2 percent has diminished somewhat."
- Moreover, while running about at-target in rate-of-change terms, the US price level is still below-trend. So even with the perceived risk of deflation receding, we know that the Yellen Fed's "optimal control" doctrine calls for it to deliberately overshoot its inflation target (see "It's Yellen's World, and We're Just Living In It" June 18, 2014). So the fact that inflation data is running at-target is, in itself, no reason to think that the Fed will cease to implement policies designed to make it higher still.
- *Against this backdrop of at-target inflation and a Fed committed to driving it even higher, the US 10-year yield at 2.40% is only priced for a premium above CPI of a mere 40 bp. <u>Over the last 100 years, that premium has averaged 1.57%.</u>*
- On the face of it, then, the Treasury market is implicitly predicting a large drop in inflation. We generally have great respect for signals from markets. But we think the Treasury market is wrong on this one -- and for what it's worth, we note that its track record in forecasting inflation and deflation has actually been quite poor (please see the graphical narrative below).




Source: Ibbotson, BLS, Bloomberg, TrendMacro calculations

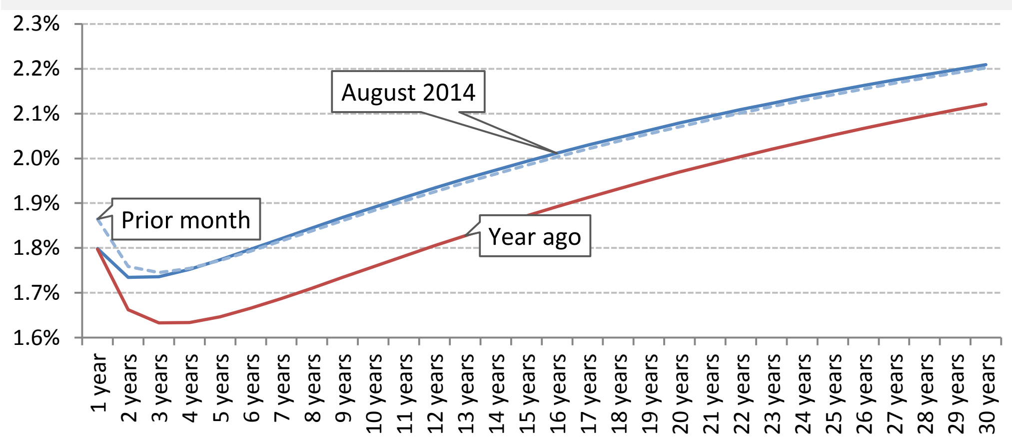
- For what it's worth, while the US TIPS market has had a poor prediction record too (please see the graphical narrative below), we note that it is not implying anything like the deflationary trend seemingly implicit in the 10-year yield. The 5-year TIPS breakeven 5 years forward is presently 2.5% -- down precisely Draghi's 15 bp from July, but hardly an alarming level.




Source: Ibbotson, BLS, Bloomberg, TrendMacro calculations

- And, again for what it's worth, long-term inflation expectations derived from the US inflation swaps curve are similarly well-behaved (please see the chart below).

**Cleveland Federal Reserve expected inflation yield curve**
Market-implied per annum rate




Source: Cleveland Fed, TrendMacro calculations

- So we continue to assert that the present low nominal 10-year yield is, in fact, a response to "the Yellen Rule" -- or for that matter, to a variety of technical factors that frequently get mentioned in client meetings -- geopolitical risk safe-haven demand, dwindling supply, appetite for duration, Chinese purchases, or some form of arbitrage-spillover from Europe.

We acknowledge that we live in a Rogoff-Reinhart post-crisis world, in which the default assumption must be that the natural background tendency in the global economy is toward deflation, not inflation.

- *But throughout the crisis and its aftermath, we think investors have consistently underestimated the extent to which central banks have both the will and the way to fight against that tendency.*
- *Today we think the US Treasury market is making a version of that same mistake -- this time correctly seeing the shape of future policy, but incorrectly assuming it will fail.*
- We have a new Fed chair who, again, is not only dedicated to fighting low inflation, but who won't stop until she overshoots (again, see "It's Yellen's World, and We're Just Living In It").
- So far Yellen, like Ben Bernanke before her, has had to fight from behind the zero-bound on interest rates, with the Fed's tool-kit limited to quantitative easing and forward guidance -- with the latter very poorly used until this year (again, see "The Yellen Rule is Taylor Minus Two"). Now that the economy has recovered sufficiently that a positive nominal funds rate will soon be feasible, the Fed is about to get its most effective tool back.
- Positive but below-normal rates -- with forward guidance promising the continuation of that regime virtually forever -- is a most powerful tool indeed.
- If, as Milton Freidman said, "inflation is always and everywhere a monetary phenomenon" -- and with Yellen at the helm of the Fed and guided by "optimal control" -- we think the chances of a return to low levels of inflation now being experienced in the euro area, and apparently implied by US Treasuries, are vanishingly small, in the absence of a large systemic shock.
- So while we have been surprised by the drop in long-term Treasury yields this year -- admittedly, we definitely did not expect it (see "2013: The Year of Living Not Dangerously" December 31, 2013) -- we must continue to argue that it has run its course and will be reversed. As US inflation holds up, and as growth accelerates, we expect the 10-year yield will correct higher.

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**Bottom line**

There is no deflation evident in the US, despite the euro area deflation emergency that Draghi has cooked up with dubious data. That will probably lead to a details-light announcement of ABS purchases at this week's ECB policy meeting. But to the extent that low long-term Treasury yields are implying a drop back to too-low US inflation, we believe they are wrong, and will have to be corrected. Treasuries have a poor track record as inflation predictors -- and from today's at-target inflation levels, we have a new Fed chair dedicated to intentionally overshooting, and about to get her most powerful policy tool back as the funds rate moves above the zero-bound.