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MACROCOSM

The Deflation Hoax

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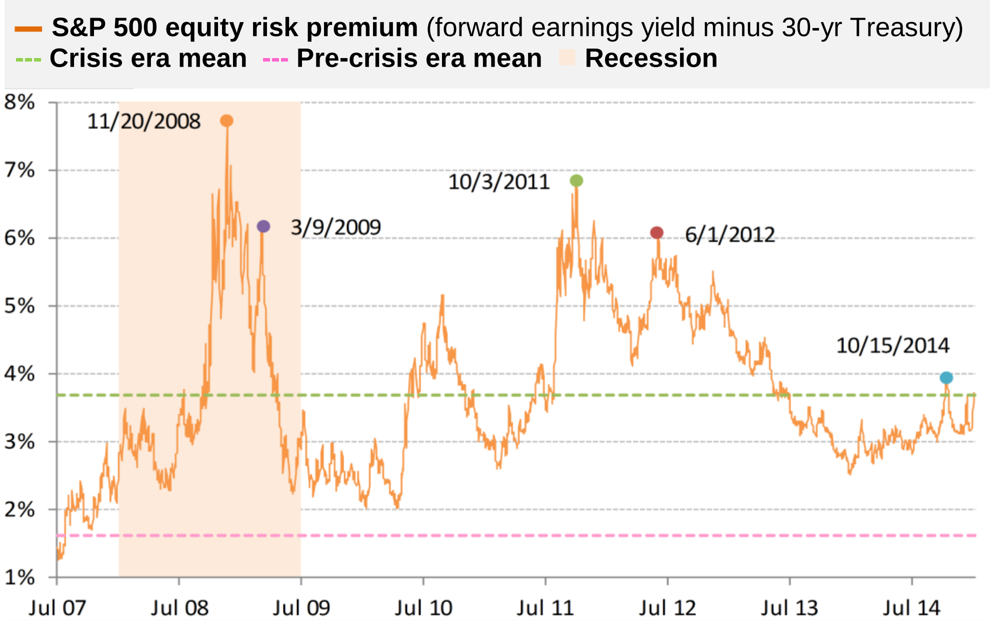
Donald Luskin

A 10-year yield below 2% doesn't imply a blow to growth, nor monetary deflation.

Global market turmoil has rung in an unhappy New Year, with US stocks experiencing a 5%-plus correction, and the US 10-year yield driven below 2%. Seems to us that Greece has been the news-driver -- it's risk-off when Germany threatens to get tough with Greece if it reneges on its bail-out after the January 25 election, and all-clear two days later when Germany signals it will work with Greece to ease its debt burden. We remain skeptical that Greece's insurgent SYRIZA will win the election, will be able to form a government if it does (see "Yes, It's Another Greece Crisis" December 10, 2014), or that it would matter much if Greece defaulted (again) or somehow gradually dropped out of the euro currency union (see "Here Come Greek Elections -- and QE from the ECB" December 30, 2014).

- *So it seems quite overdone to see the S&P 500 equity risk premium (ERP) back up to its crisis-era mean* (please see the chart below).
- *This is so not a crisis. And for those who think a US 10-yield below 2% is saying otherwise, we respectfully disagree.*



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US BONDS, US STOCKS, EUROPE MACRO, OIL: Global market turmoil has driven the S&P 500 equity risk premium back to its crisis-era mean. We think this will once again prove to be a ceiling. The US 10-year below 2% should not be taken as a warning of a blow to growth. It reflects primarily a sharp drop in inflation expectations, coinciding with the sharp drop in oil prices. This does not imply a deflation crisis, either here or in the euro area. Breathless claims to the contrary are a hoax. The oil price drop is the result of a productivity revolution, not a monetary error as in 2008-2009. We have to get through the Greek elections, possible instabilities in US oil producers, and perhaps another cold winter. But the theme for 2015 remains a massive and positive oil shock that will drive growth and stock prices -- and Treasury yields -- higher over the year.

[Strategy Dashboard home]

Let's go back just two and half years in time and remind ourselves what a real euro crisis looks like.

- In mid-June 2012, Greece faced an election that looked exactly like the upcoming one -- New Democracy versus SYRIZA (see "Εκλογη" June 15, 2012). All the same issues and risks were in play.
- The US 10-year was below 2% -- in fact, it was at 1.57%.
- *The difference is that, then, there was credible widespread fear that a Greek default or exit from the euro would trigger defaults in Italy and Spain and a run on the currency causing a catastrophic 17-way break-up.* Fear was running so high that the Italian 10-year yielded almost 6% (on the way to almost 7%), and the Spanish 10-year yielded almost 7% (on the way to almost 8%).
- *ECB President Mario Draghi's "whatever it takes" speech in London on July 25, 2012, changed all that, creating institutional credibility that euro area sovereign debt would always be backstopped and that the euro currency was "irrevocable"* (see "On Draghi in London" July 26, 2012). So today, though Greece is flailing again, the Italian 10-year yields only 1.9%, and the Spanish only 1.7%.

So if this time is different in the euro area, why did the US 10-year fall below 2%?

- *It has little to do with Europe, and everything to do with oil -- or, more specifically, with the impact of lower oil prices on both growth (positive) and inflation (negative).*
- Consider that in June 2012, while the US 10-year *nominal* yield was 1.57%, the *real* yield (that is, the 10-year TIPS yield), was *negative* 0.58% (heading to almost negative 1%). *That's what it looks like when the Treasury market is scared, and is forecasting a blow to growth.*
- The *real* US 10-year yield almost touched zero last mid-October, at the peak of the global Ebola freak-out (see "Something You Probably Didn't Know about Ebola" October 14, 2014). *That, too, is what it looks like when the Treasury market is scared.*
- But today, the real US 10-year yield is positive 0.39% -- that is, 97 bp higher than it was in 2012.
- *The arithmetic is simple. The drop in the* nominal *10-year yield to below 2% this week has been another leg down in the collapse of the inflation premium as oil prices have fallen.* From when we called the 2014 top in oil (see "The Stench of CrISIS" June 25, 2014), the 10-year TIPS breakeven spread has fallen from about 2.3% to about 1.6%. We don't like it when market commentators use scare-words like "plunge" to describe moves like this, but this time it fits.
- To be sure, last year US Treasury yields -- real and nominal -- had to drop in order to take on board the arrival of what we call "The Yellen Rule," the promise of a lower-than-normal funds rate virtually forever (see "The Yellen Rule is Taylor Minus Two" May 19, 2014).

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[About us]

Recommended Reading

The Value of Smarter Teachers: International Evidence on Teacher Cognitive Skills and Student Performance
Eric A. Hanushek, Marc Piopiunik and Simon Wiederhold
NBER Working Paper No. w20727
December 2014

Let this be the year when we put a proper price on carbon
Lawrence Summers
Financial Times
January 4, 2014

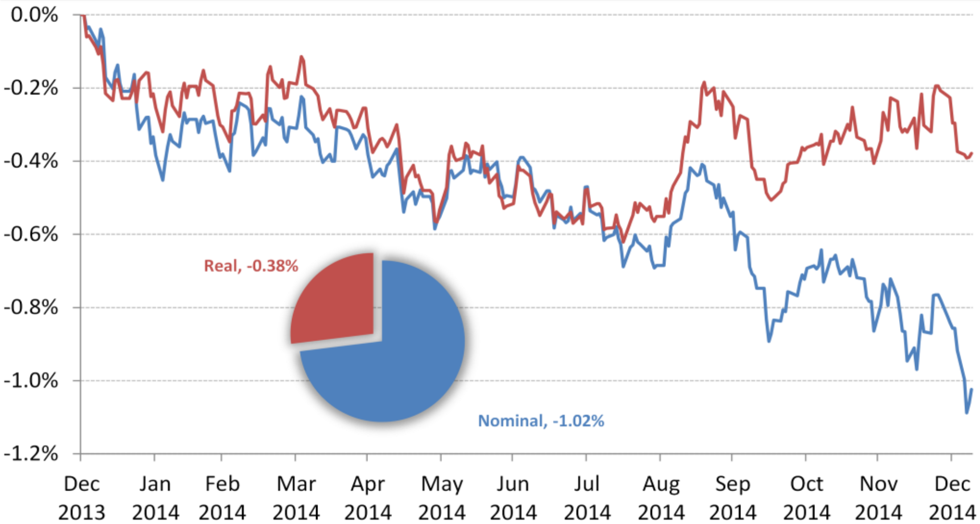
Stability and Prosperity in Monetary Union
Mario Draghi
Project Syndicate
1/2/2015

Gasoline-Tax Increase Finds Little Support
Patricia Cohen
New York Times
January 2, 2015

[Reading home]

- But as we documented last week (see "2015: Oil Change for the Global Economy, US Edition" December 31, 2014), in the back half of 2014 *real* yields climbed while *nominal* yields fell (please see the chart below). Again, this implies to us a rational absorption by the Treasury market of the pro-growth and anti-inflation consequences of a durably lower oil price.

10-year Treasury, change in yield from year-end 2013 — Real — Nominal

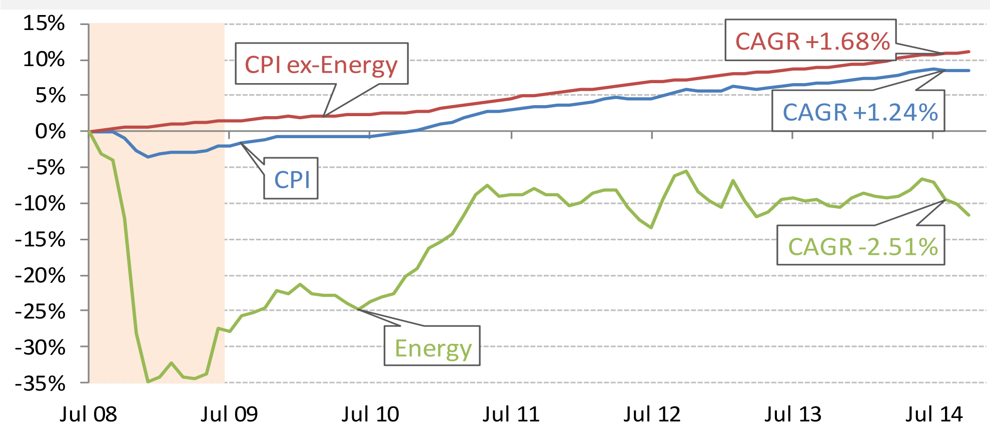


Source: Bloomberg, TrendMacro calculations

But wait. Isn't deflation, or even too-low inflation, a bad thing?

- *If is results from a central bank policy error of excessive tightness, then yes.*
- *But if it results from a productivity revolution -- like the one we have seen over the last three years in oil production through horizontal drilling and hydraulic fracturing -- then no.*
- We've had it both ways since the peak in global oil prices in July 2008 (please see the chart below). Taking energy out of the US

US Consumer Price Index Change from July 2008 **Recession**

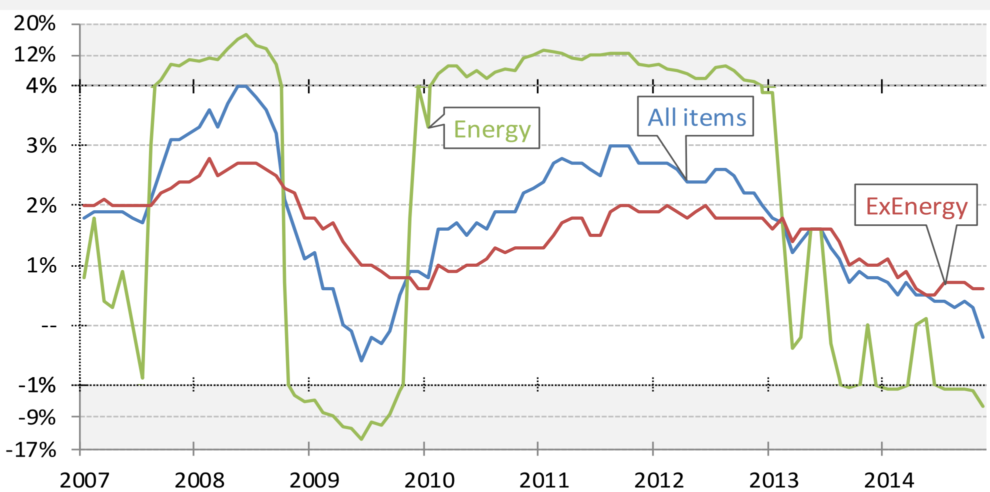


Source: BLS, NBER, TrendMacro calculations

Consumer Price Index, the outright deflation we saw in 2008 and 2009 seems to be non-existent. But there's no good reason to take energy out -- the sharp drop in global oil prices in the Great Recession was a demand shock that was part and parcel of a tightening of financial conditions to which the world's central banks did not respond quickly or forcefully enough. That deflation was genuine, and worthy of the word -- it was a true *monetary* deflation.

- But the flattening of CPI we're seeing now -- no doubt it will turn into an outright fall shortly -- is entirely different. As in 2008-2009, if we remove energy it goes away. But this time there is a good reason to take energy out. The sharp 2014 drop in oil prices is not a demand shock at all, but rather a technology driven supply shock (see "Don't Let a Good Oil Crisis Go to Waste" October 21, 2014).
- Based on the most recent FOMC statement and minutes, the Fed seems to see it as we do (see "On the December FOMC" December 17, 2014). *This is very good news. It means that the Fed will not make the mistake -- nor seize the opportunity -- to stay too accommodative for too long under the cover of too-low inflation.*
- But in the euro area, the ECB seems to be unable to draw these distinctions. In his most recent post-Governing Council meeting press conference, Draghi admitted that the sharp drop in oil prices was "unambiguously positive." But in the same breath clung to the alarmist deflation narrative he set in motion in August in Jackson Hole (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014) -- fretting that "lower [oil] prices get embedded in a lower wages formation process."
- Yesterday, in reaction to the release of euro area inflation data with a negative 0.2% year-over-year headline rate, the ever-sensationalistic London press declared "Eurozone falls into deflation" -- mentioning only *en passant* that core inflation had actually ticked *up* on the month, to positive 0.8%. *This kind of press coverage is, in essence a hoax.*
- *The reality is that for the euro area, as for the US, the fall in headline inflation is all about oil* (please see the chart below) --

Euro area consumer price index Year-over-year change



Source: Eurostat TrendMacro calculations *which means it's not a bad thing.*

- By the way -- if deflation were really such a threat in the euro area, why would the euro currency be as weak as it has been? Deflation makes a currency strong.

If low inflation now isn't a bad thing, that means it's not a bad thing -- that is, not a signal of an upcoming blow to growth -- to see the nominal US 10-year at or below 2%.

- But that's not to say that it's an entirely rational thing.
- A 10-year *nominal* bond has to consider inflation rates for ten years. The present drop in oil prices is a "pig in a python" that will pass out of inflation measurements over time.
- Meanwhile, the pro-growth effects of oil being suddenly transformed from a scarcity-good to an abundance-good will drive *real* yields higher.
- The opening days of this New Year have not been kind to our year-end forecast for higher US Treasury yields (again, see "2015: Oil Change for the Global Economy, US Edition").
- We acknowledge that we're going to have to get through the Greek election and (if it goes badly) its aftermath. We'll have to get through any financial instabilities that arise from stresses in the domestic energy industry. And -- writing these words in Chicago -- we may have to get through another Polar Vortex.
- But none of that changes our major theme for the New Year: the world is undergoing a massive positive oil shock.
- We think that theme will get the global economy through any short-term challenges (none of which seem particularly intense anyway), and lead to a great deal of upside surprises -- for growth, for stocks, and for Treasury yields.

Bottom line

Global market turmoil has driven the S&P 500 equity risk premium back to its crisis-era mean. We think this will once again prove to be a ceiling. The US 10-year below 2% should not be taken as a warning of a blow to growth. It reflects primarily a sharp drop in inflation expectations, coinciding with the sharp drop in oil prices. This does not imply a deflation crisis, either here or in the euro area. Breathless claims to the contrary are a hoax. The oil price drop is the result of a productivity revolution, not a monetary error as in 2008-2009. We have to get through the Greek elections, possible instabilities in US oil producers, and perhaps another cold winter. But the theme for 2015 remains a massive and positive oil shock that will drive growth and stock prices -- and Treasury yields -- higher over the year.