Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist

MACROCOSM

Unyielding

Wednesday, May 13, 2015

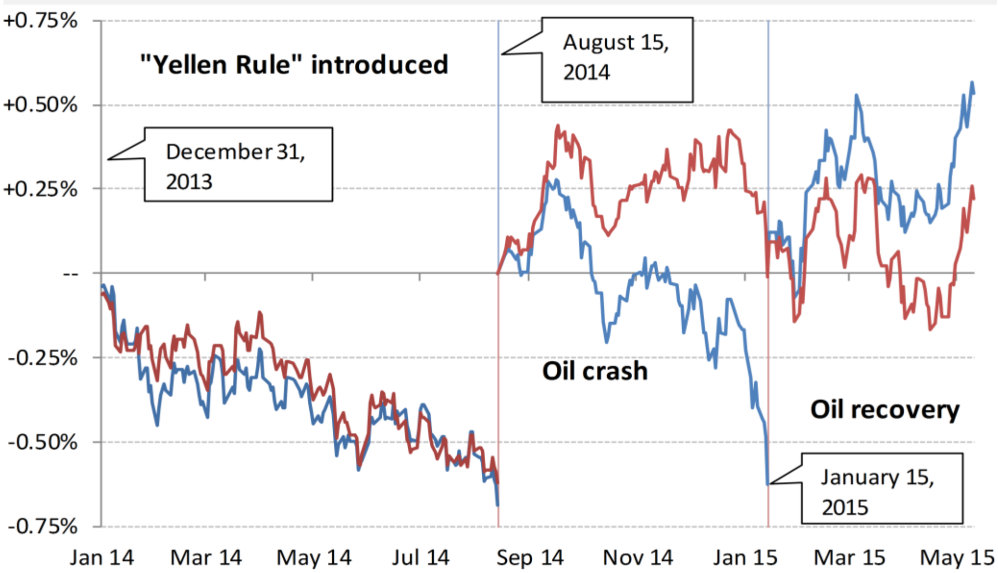
Donald Luskin

Rising yields mean we just avoided history's first recession caused by low oil prices.

Long-term bond yields are rising world-wide, and it's raising some degree of alarm. Funny, but while yields were falling most of this year, that raised some degree of alarm, too. It seems markets just enjoy being alarmed.

- We think it's fairly straightforward. Long-term Treasury yields fell through the first eight months of last year as Janet Yellen arrived on the scene and announced what we've called "The Yellen Rule" -- a systematically lower funds rate forever (see "The Yellen Rule is Taylor Minus Two" May 19, 2014). As the "dots" for the "longer run" funds rate fell about 75 bp (see "The Fed's Growth-Friendly 'Dot' Gap" September 19, 2014), so did both nominal and TIPS yields (please see the left-most segment of the chart below).
- Then from mid-August last year to mid-January 2015, while oil prices crashed, real yields were broadly unchanged. But nominal yields fell about another 75 bp as inflation expectations followed oil prices lower (please see the center segment of the chart below).
- Then from mid-January on, as oil prices recovered, so did inflation

Change in US Treasury 10yr yield — Nominal — TIPS



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US BONDS, EUROPE BONDS, US MACRO, EUROPE MACRO, OIL, FX, US FED, ECB: The global back-up in long-term yields should not be alarming. It represents rising inflation expectations as oil prices recover to the top of our forecasted range, and relief from systemic credit risk, excessive dollar strength, and recession risk that had been flirted with when there might have been a fire-sale in oil to as low as $20. The back-up in the euro area is evidence that ECB QE is working, similar to back-ups seen all three times the Fed did QE. We reiterate are calls for the top of the range for oil at $65 (allowing for some overshoot), a top in the US dollar, and the US 10-year yield drifting up to 2.75% by year-end.

[Strategy Dashboard home]

expectations. So nominal yields rose again, while real yields remained generally unchanged (please see the right-most segment of the chart on the previous page).

But it's more than just a matter of inflation expectations. Those are only one aspect -- one of the more benign aspects -- of a potentially vastly consequential spillover from the crash in oil prices that began last June.

- The revolution in production of oil from shale portends a growth-supportive future of secularly lower and less volatile energy prices. But in the short term, horizontal drilling and hydraulic fracturing are "disruptive technologies" that threaten a *status quo* embedded in the global economy for more than a century and a half. If Goldman had been right and oil had traded down to $30, and all the more if Citi had been right and oil had traded down to $20 (see "Grant Me $20 Oil, But Not Yet" February 17, 2015), we'd have seen annihilation in credits, businesses, institutions and whole governments geared to monopoly control of scarce and expensive oil.
- Through the connection of falling oil prices to a stronger US dollar (see "Dollar Strength: A Crude Connection" April 23, 2015), we'd have seen more profit pressure on US multinationals and exporters, and for emerging market dollar creditors.
- Already, in the first quarter, we estimate that falling capital investment in the energy sector and the strong dollar took about 1.75% off real GDP growth at an annual rate even before considering spillover effects (see "On the April FOMC and Q1-15 GDP" April 29, 2015).
- *At the lows in yields and in inflation expectations, we think the market was anticipating a catastrophic fire-sale in oil that, thankfully, never materialized.*
- *The back-up in yields means the global economy has managed to avoid the very unusual risk it has faced all year: the possibility of first recession in history caused by* falling *oil prices* (see "Houston, You're the Problem" March 9, 2015).
- Now crude oil prices rallying back to the top of the trading range we called for at the bottom in January (see "Oilmageddon: The Sequel" January 15, 2015) means a reprieve, and opens a path back to the higher growth rates we were seeing in the second and third quarter of 2014 before the oil crash had really gotten underway.

We really doubt that the global back-up in yields has a lot to do with any credible threat that the Fed will activate "liftoff" from the zero bound on rates sooner than expected, or after that, raise rates particularly aggressively. We can't interpret April's FOMC as doing anything but ruling out a June liftoff (see "On the April FOMC and Q1-15 GDP" April 29, 2015).

And we are not especially alarmed by the sudden, sharp and very large back-up in euro area yields.

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
713 893 1377
mike@trendmacro.com

[About us]

Recommended Reading

There Is No "Blue Wall"
Nate Silver
538
May 12, 2015

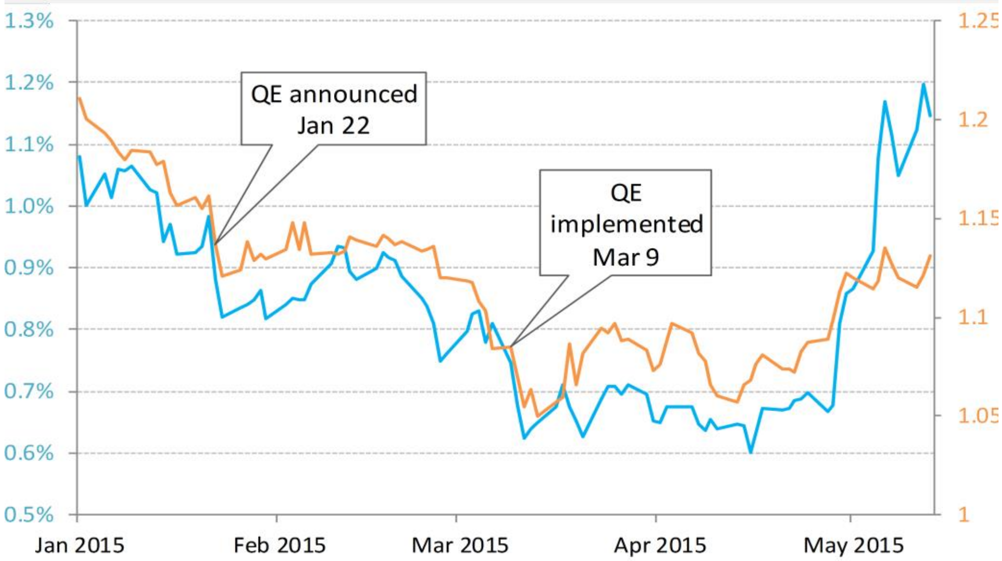
Drillers Answer Low Oil Prices With Cost-Saving Innovations
Clifford Kraussmay
New York Times
May 11, 2015

Labour power sets the neutral real rate
Toby Nangle
VoxEU
May 9, 2015

[Reading home]

- For Europe, too, we think it's good news.
- It's certainly attention-getting, especially considering the odor of systemic risk left over from the last crisis episode in 2012 -- especially as negotiations with Greece continue to be dragged out without resolution.
- But spreads between yields in the periphery and the core haven't especially widened out, as we'd expect if a systemic event were brewing.
- We can't explain the exact timing of the sudden leap in euro area yields. But as a general proposition we'd point out that inflation expectations have changed dramatically for the better with the present rally in oil prices. Indeed, energy alone explains the entire experience of year-on-year euro area inflation below zero. Without energy, it never happened -- and now it's over (see "The Deflation Hoax" January 8, 2015).
- At the same time -- and at first glance, perversely -- the back-up in euro area yields is likely in part the result of the European Central Bank's quantitative easing program. We predicted in January, when ECB QE was first announced, that it "will ultimately drive yields higher, just as QE did every time in the US, and strengthen the already weakened euro" (see "On the January ECB Policy Meeting" January 22, 2015). Indeed that is just what happened (please see the chart below).

Average euro area 10yr sovereign yield **EUR/USD exchange rate**
DE, FR, IT, ES, ND, BE weighted by ECB capital key

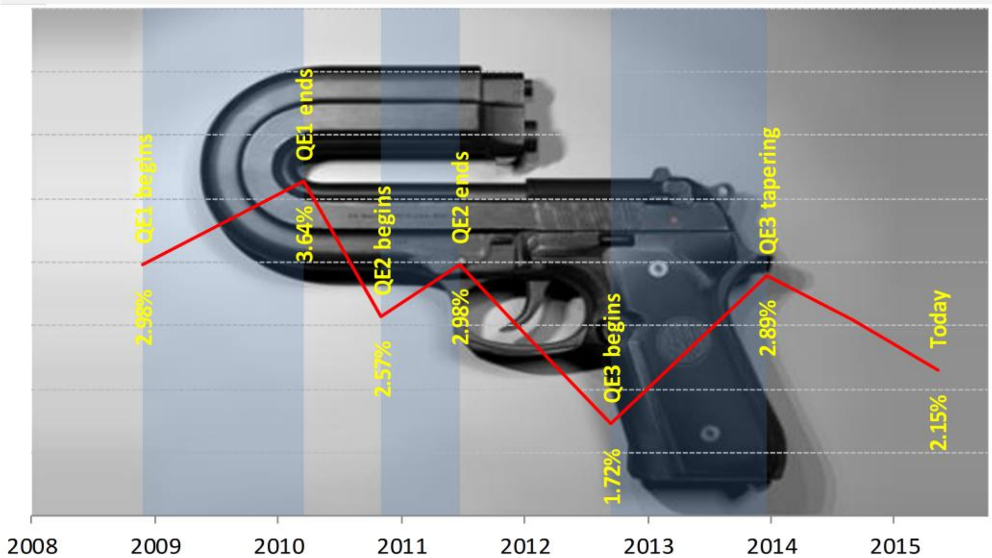


Source: Bloomberg, ECB, TrendMacro calculations

- Supposedly QE works by stimulating the economy by lowering *long*-term yields. But surely that cannot be so. The *goal* of QE is to stimulate growth and raise inflation expectations, so *if it is working*, then long-term yields (which are a function of growth and inflation expectations) would move higher, not lower.
- *Indeed, if long-term yields did not go up in response to QE, then QE would have failed. Rising yields means QE is working*

- This has been borne out in the US experience with QE, in which all three times the Fed began a Large Scale Asset Purchase (LSAP) program, long-term yields went up. When the LSAPs ended, yields went back down. As we say, this proves that the Fed never runs out of bullets, but its gun shoots backwards (please see the chart below, and "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).

US Treasury 10yr yield Nominal **Period of LSAP in effect**



Source: Bloomberg, Federal Reserve, TrendMacro calculations

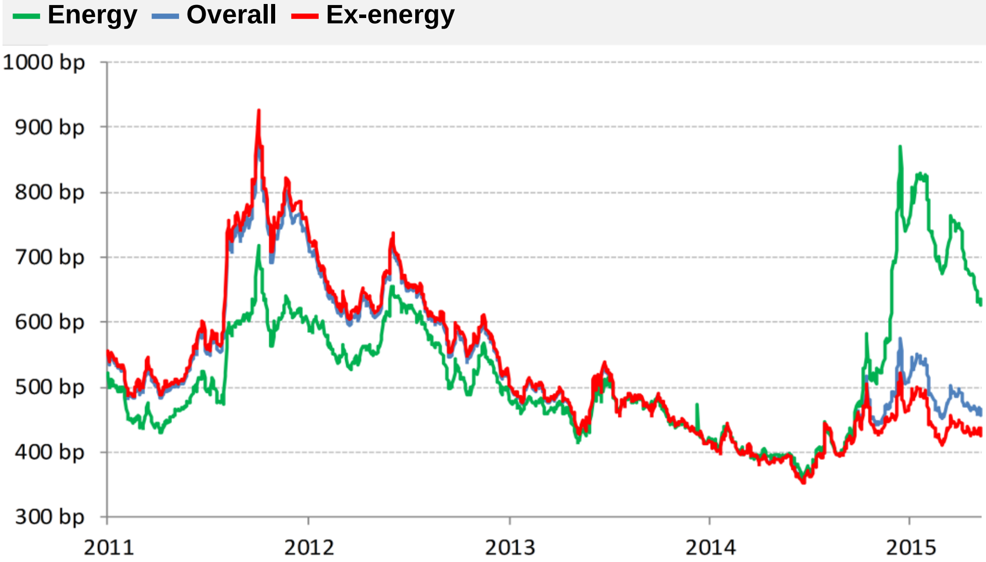
Looking ahead, let's assume we are correct that oil, inflation and the ECB's QE have been the drivers of yields. We know with near certainty that the ECB is going to keep QE going for the foreseeable future. And we're confident in our forecast that (1) capacity overhang will keep oil from moving much higher than it is now, allowing for the usual short-run speculative overshoot, and (2) demand will keep oil from revisiting the lows seen earlier this year.

- *With oil range-bound, then if oil's connection to the US dollar remains intact, then the dollar is range-bound too.*
- That means that the two source of instability and potential risk that have taken such a heavy toll over the last two quarters will be sidelined.
- And with oil no longer falling, inflation will stop being as alarming low as it has been -- but with oil no longer rising, inflation won't get out of control on the upside either. Indeed, the disinflationary effects of a durable shift lower in oil prices versus the punishing highs seen throughout the era of so-called "secular stagnation" will leak into the price level for years.
- *That's a very growth-friendly combination -- with forces of destabilization abating, lower energy prices creating a "peace dividend" for consumers and producers, and tame inflation not*

acting as a binding constraint against accommodative central bank policy as growth picks up.

- We're already beginning to see some very encouraging signs. Let's review two of the most alarming symptoms we'd observed during this period of oil-driven disruption (again, see "Houston, You're the Problem").
- First, the violent back-up in spreads in the energy sector in US non-investment grade bonds has significantly abated (please see the chart below). The disastrous credit events that would have surely occurred had oil fallen to $30 or $20 seem to have been avoided.

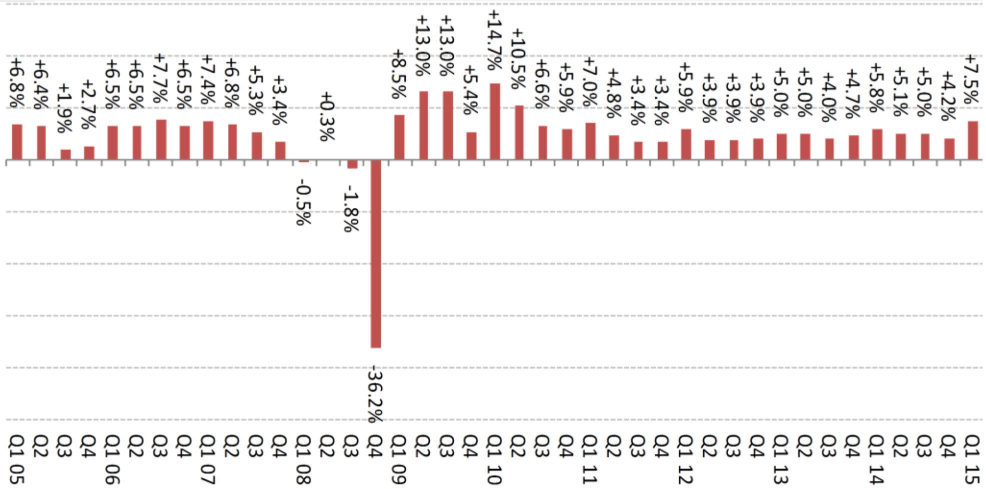
Merrill Lynch High Yield Master Index, spread to Treasuries



Source: Merrill Lynch, TrendMacro calculations

- The rollover in S&P 500 forward earnings starting last October has been, for us, the most alarming harbinger. At the worst at month-end February, forward earnings had fallen 5.6% from peak. Now from that trough they've recovered 1.6% in just two and a half months, an annual rate of 7.8%. Excluding energy, the recovery has been 1.8%, or 8.7% at an annual rate.
- Over just the last two weeks since their trough on April 24, even the beleaguered energy sector's forward earnings have begun to recover -- by a rather astonishing 5.5%.
- By our reckoning, not a single company in the S&P 500's energy sector with a March-ended quarter failed to beat consensus earnings expectations. Overall, the sector contributed 26% to the aggregate dollar value of net "beats" this earnings season -- no mean feat, considering that this earnings season has been the best since Q2-2010 (please see the chart on the following page).
- This is especially encouraging because this earning season has had the most evenly distributed pattern of "beats" that we can recall. In many earnings seasons, the vast majority -- sometimes more than all -- of the net "beat" is concentrated in blockbuster numbers from just the top ten companies, usually banks and tech firms. This time, the top ten (of which the top two were energy

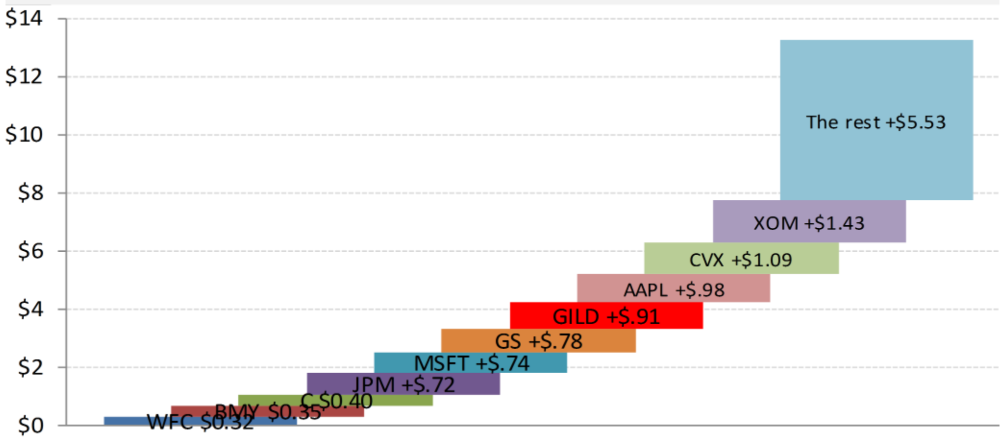
Net beat/miss versus consensus earnings expectations
Percent of aggregate dollars of earnings



Source: Bloomberg, TrendMacro calculations

companies), make up only 58% of the net "beat." This tells us that the infection that had been spreading from the distressed energy sector to the rest of the corporate economy has been arrested and reversed (please see the chart below).

Aggregate net earnings surprise USD billions, S&P 500 quarter-ended March



Source: Bloomberg, TrendMacro calculations

Bearing all this in mind -- growth accelerating, inflation tame, and central banks still accommodative -- we would expect to see yields move a little higher over the rest of the year, but nothing alarming. We'll reiterate our call for 2.75% on the nominal 10-year by year-end (see "2015: Oil Change for the Global Economy, US Edition" December 31, 2014).

Bottom line

The global back-up in long-term yields should not be alarming. It represents rising inflation expectations as oil prices recover to the top of our forecasted range, and relief from systemic credit risk, excessive dollar strength, and recession risk that had been flirted with when there might have been a fire-sale in oil to as low as $20. The back-up in the euro area is evidence that ECB QE is working, similar to back-ups seen all three times the Fed did QE. We reiterate are calls for the top of the range for oil at $65 (allowing for some overshoot), a top in the US dollar, and the US 10-year yield drifting up to 2.75% by year-end.