



Economic Perspectives

Real yield suppression

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Nominal yields vs inflation expectations ...

- ... a two-horse race



Real yield suppression: keeping the punchbowl full

- Benchmark government bond yields and inflation expectations are locked in a 2-horse race.
- If real recovery takes hold while inflation expectations are capped, nominal and implied real yields rise in tandem and the optimists win.
- If real recovery falters but inflation expectations keep rising, even if nominal yields are restrained, real yields will fall.
- Falling real yields imply a change of equity market leadership and a sweet spot for inflation-protected bonds

One horse on sedatives, one horse on steroids

- In this contest between nominal T-bond yields and inflation expectations, yields are being restrained while inflationary forces are being reinforced.
- Central bankers and establishment voices are dismissive of the idea that inflation will persist at levels inconsistent with policy mandates.
- However, the surge in US core inflation is not readily excused; the issues relate to capacity shortages, a dearth of raw materials and parts, interrupted supply chains and structural changes in the labour market etc.

Inflation: a richer narrative (1)

- Melt-up scenario is the credible inflationary trigger
- Public sector budget deficit reduction will squeeze the private market sector – lurch toward a command economy and smaller SME sector
- Public sector demand for labour and materials is driving up the aggregate price level
- Impending market-led credit tightening will force a tidal wave of bankruptcies and business closures
- Semi-permanent contraction of supply will keep inflation strong even when the sugar-high is over

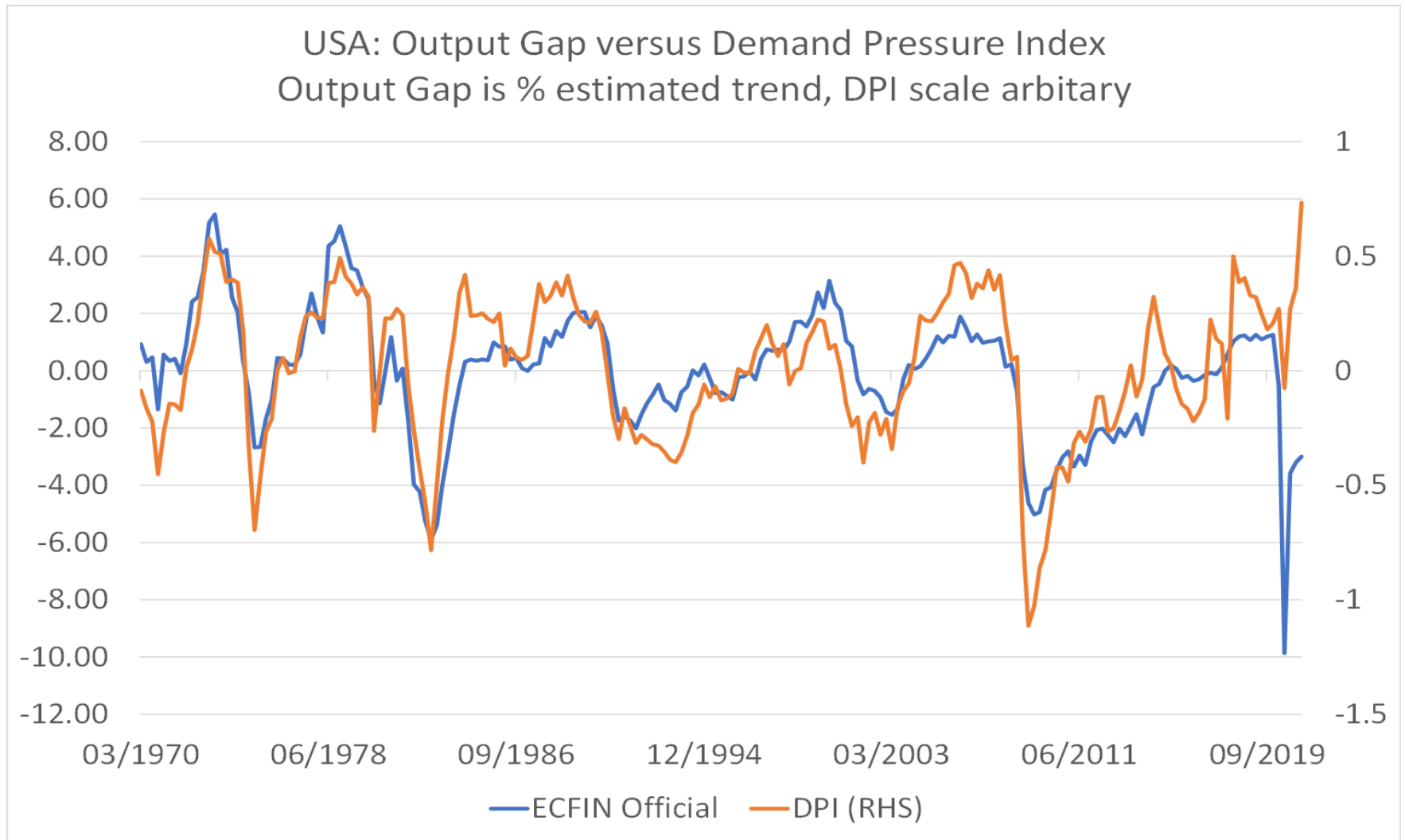
Inflation: a richer narrative (2)

- GDP inflation is faster than CPI inflation
- Home-working revolution will dominate the rise in unemployment as a driver of housing inflation
- FAO food price index at its highest since 2014. Covid-19 limited the planting of crops in 2020 and subsequent harvests; this is likely to recur
- Non-food commodity price increases are driving up construction and industrial costs. Natural resource 'nationalism' becoming more evident
- E&D expenditures have plummeted since 2014, meaning curtailment of new sources of supply

Inflation: a richer narrative (3)

- Disruption of the public's inflation expectations as frequently-purchased items have risen in price more obviously than the CPI
- Central banks have failed to explain the rationale for significant additions to QE, implying a loss of inflation-objective credibility
- QE has brought a massive acceleration in the growth of the broad money supply (M3/M4)
- Fears of a second 'taper tantrum'
- Fears of a broadening of 'yield curve control', suppressing nominal bond yields

Bottom-up capacity indicator tells a different story



Demand Pressure Index – constituent indicators

ISM new orders – inventories

Wholesale inventory ratio

M3/GDP

Real share prices

Yield gap

House prices vs earnings

GDP output gap simple model

Capacity use survey

Jobs growth / unemployment

Average hours worked

Import penetration (consumer goods)

Import penetration (CAPEX)

Budget Deficit

Productivity vs trend

Unfilled orders vs production

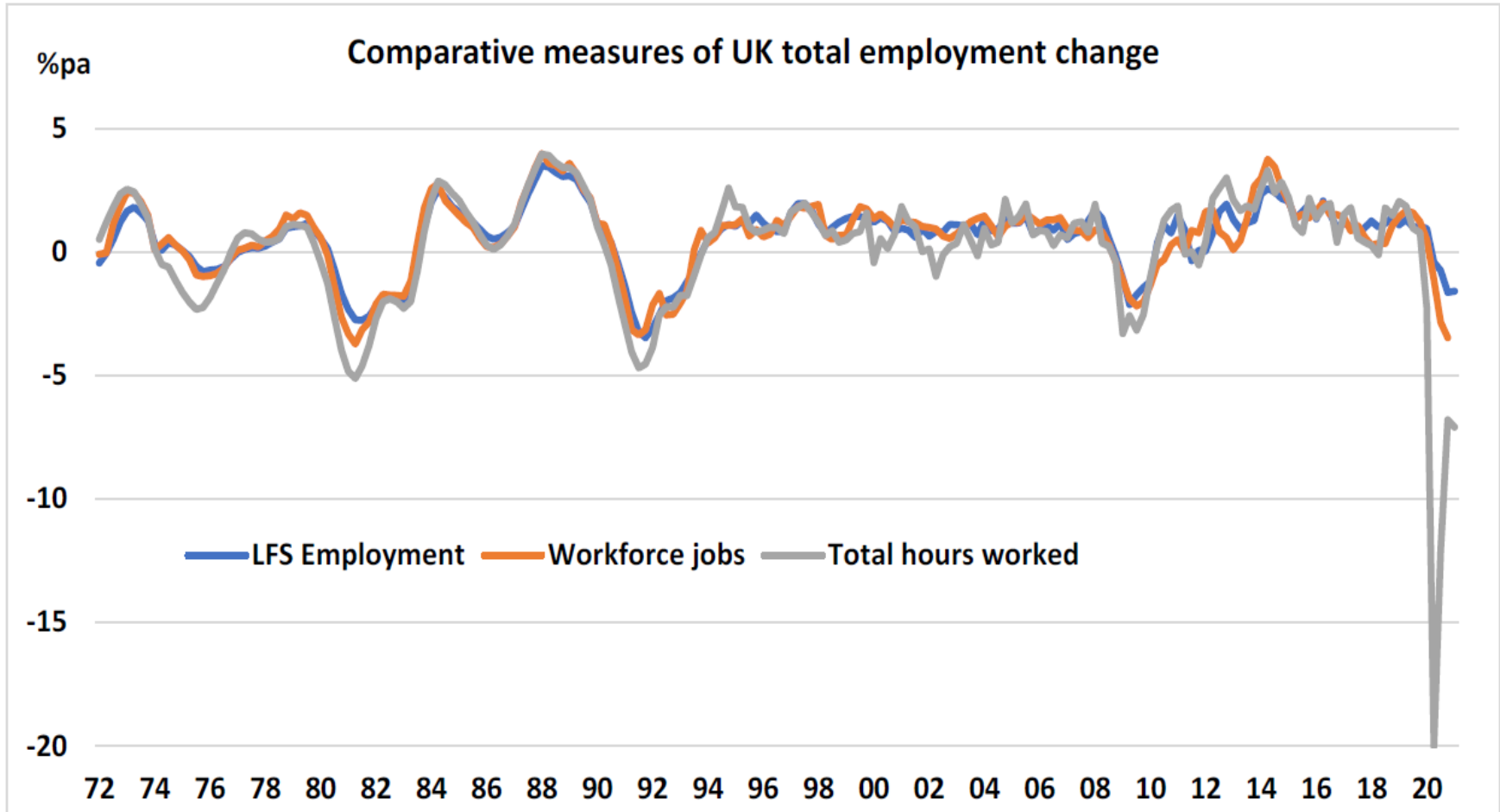
Corporate internal cash flow in real terms versus trend

Private Sector Credit growth % GDP

Labour markets remain key inflation battleground

- Mass abstentions from labour participation – will they persist after emergency payments are scaled back?
- Structural changes in labour market have reduced its matching efficiency – extreme levels of job vacancies and poor fill rates
- Employers paying up to attract suitably qualified labour and offering loyalty bonuses for staying
- Carnage in the SME/self-employed sectors – how much of this employment will return?

How many jobs/workers have disappeared?



Data source: Office for National Statistics

Nationalisation of credit creation

- Post-GFC, bank credit creation has not responded to the cheapness of credit nor to cyclical indicators
- Banking regulation and the extent of unrecoverable household and SME debt has dissuaded banks from loan book expansion
- When the pandemic struck, government realised that the banks would not provide the support to the private sector that would be necessary
- State effectively nationalised credit creation and disabled bankruptcy/insolvency mechanisms

Nationalisation of credit creation

- The state has re-emerged as the dominant economic actor
- Acquiescence of central banks to expansion of state credit creation: acting in concert
- State has subverted the monetary framework to its own ends, declaring *force majeure*
- Colossal budget deficits – largely monetised by CBs
- State guarantees for ‘crisis’ bank loans
- US Fed’s historic interventions in US corporate credit markets to neuter pricing of default risk

How the credit markets have changed

- Despite rock-bottom interest rates, in some ways credit conditions have tightened in recent years
- Bank lending to SMEs has withered since GFC
- SMEs are forced to become self-financing, seek trade credit through their supply chain partners, or use a government-sponsored loan scheme
- Covid-19 lockdowns have depleted the reserves of SMEs, leaving them unable or unwilling to gear up into the re-opening phase.
- Massive implicit business shrinkage and self-employed job losses

Private sector credit creation is weak

- Bias to issuance by companies and financial institutions with poor prospects and moderate to weak balance sheets
- In 2020, Fed opened the floodgates to issuance by troubled entities, increasing moral hazard and perpetuating socialistic credit dynamics
- State is on the hook for failed loans and ongoing grants and subsidies to ailing sectors
- Tax revenues are unlikely to rebound strongly as deferred tax will be hard to collect

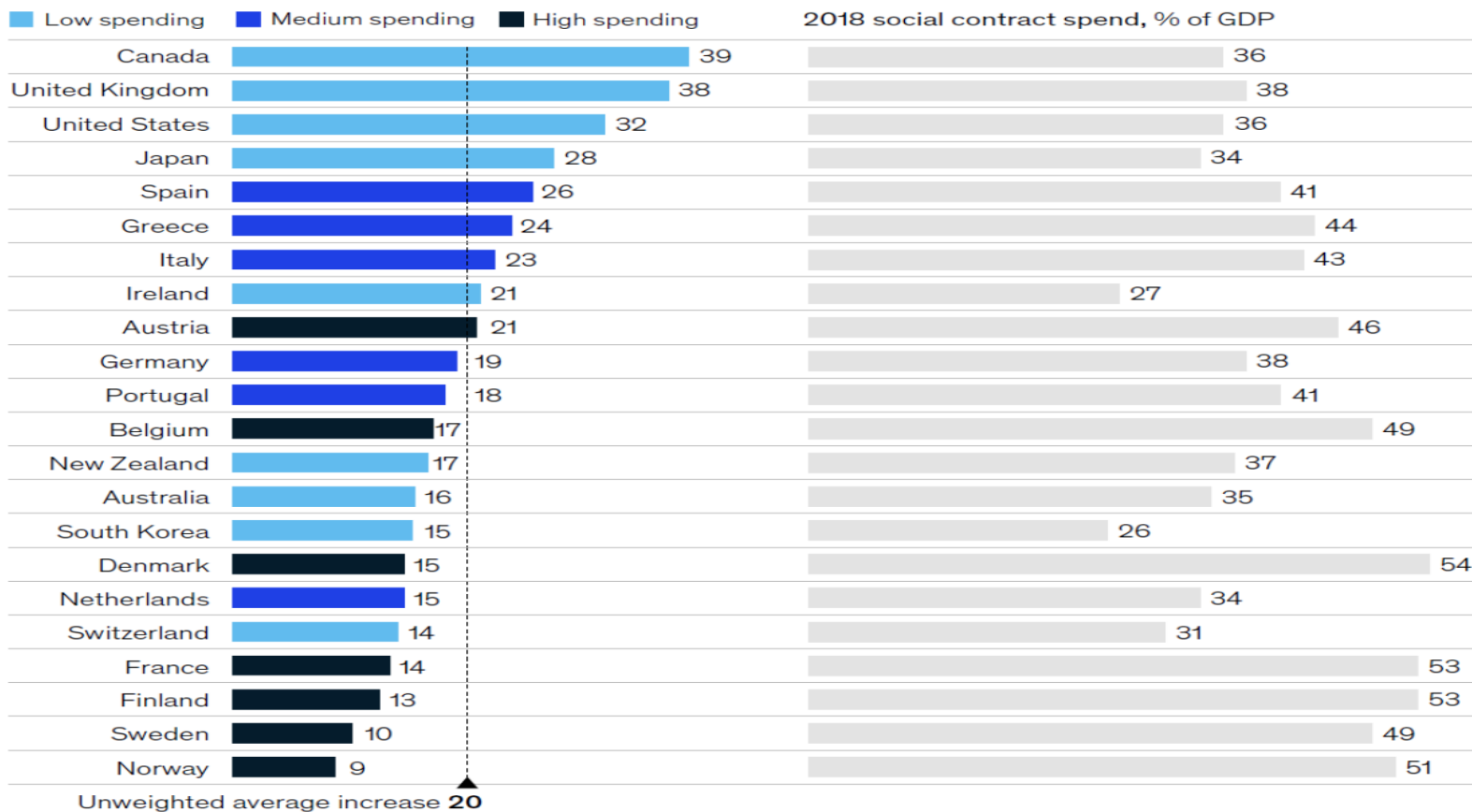
Budget deficit outlook and redrawing the social contract

- In US, UK and Canada, the pandemic has redefined public expectations of acute healthcare and social support.
- Politically impossible to return to the status quo ante – the bar has been raised
- Huge backlogs in health, social services, justice system imply even more public money is required to reduce waiting times and address the legacy issues arising from lockdown
- Governments face a Herculean task in reducing budget deficits to manageable levels

Rise in social contract spending: putting out the fires

As government expenditure rose, countries that usually spend less on the social contract have outspent higher-spending ones.

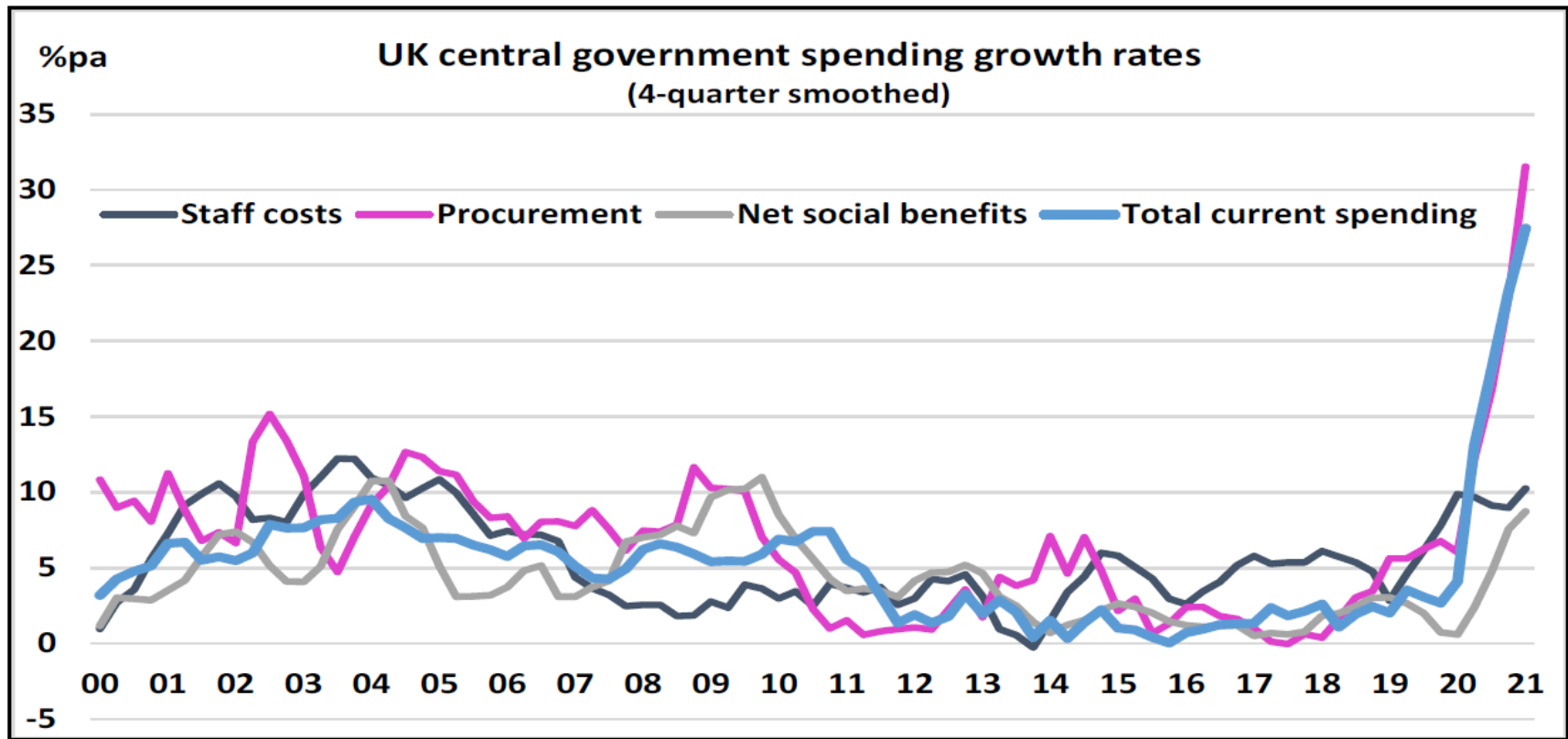
Increase in government expenditure in 2020 by archetype,¹
 % increase in 2020 vs 2019 as percentage of GDP



¹ Archetypes determined based on 2018 spending on the social contract including public-sector wages, total social spending (directed at individuals and households), for unemployment, active labor-market programs, family and other social policies, healthcare, housing, pensions, public spending on education, and government gross fixed-capital formation.
 Source: IMF Fiscal Monitor; McKinsey Global Institute analysis

Government spending has soared during pandemic ...

- ... tightening the product and labour markets



A significant nominal expansion is underway

Figure 2: Composite weighted nominal ISM versus core CPI inflation

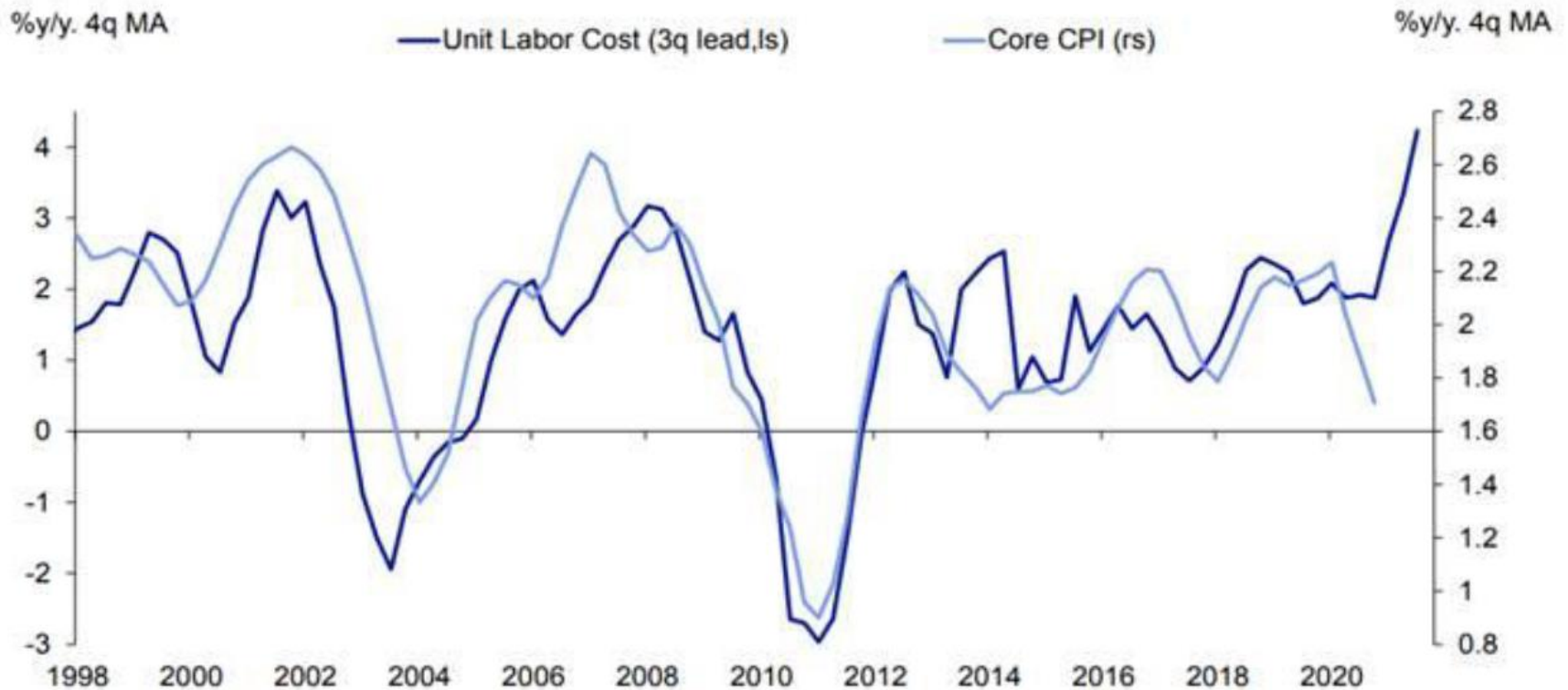


Source: Macrobond and Nordea

Covid-19: a heart attack not a recession

- Normal recovery dynamics do not apply!

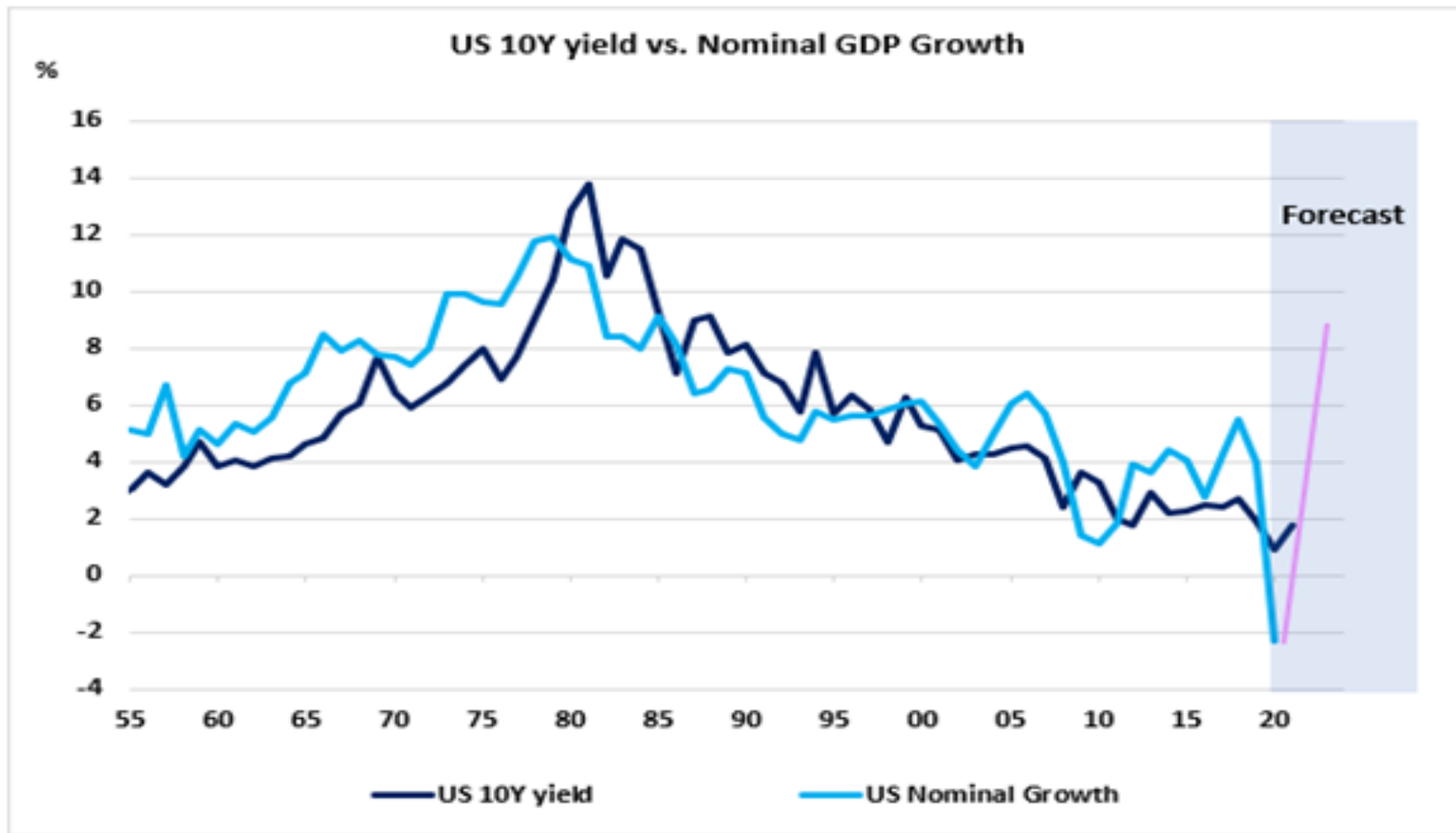
United States: Unit labor costs jumped, pointing to higher inflation ahead.



Source: BLS, Haver Analytics, Deutsche Bank

Benchmark yield inhabits its nominal GDP environment

- With a 9% bounce in NGDP, 'fair value' is 3.5%

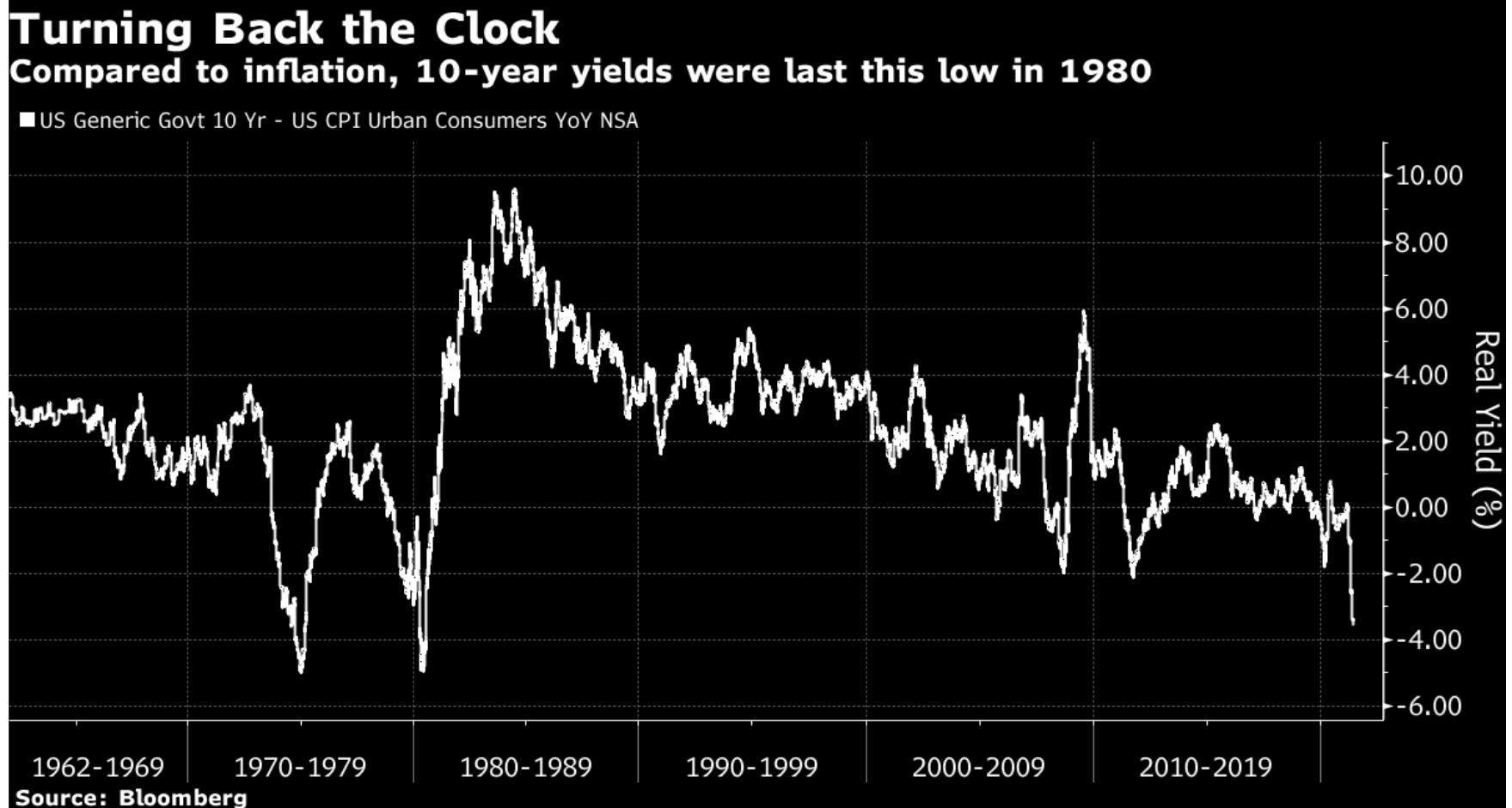


Entire edifice of financial asset prices rests on cheap credit

- Too dangerous to allow T-bonds to price in inflation risk: carries a presumption of policy tightening and a likelihood of yields overshooting
- US bond yields are restrained by significant price-insensitive buyers, by official actions to withdraw supply from the public, by the expansion of lending to financial sector by the US banking system and by Yield Curve Control in Japan and Europe
- Others are happy to buy bonds in anticipation of a weakening economy post the re-opening bonanza (e.g. Lacy Hunt and David Rosenberg).

Unanticipated inflation: lessons from the 1970s

- OPEC oil shocks were destructive to bond returns



Fixed income investors are clinging to the hope that ...

- ... 2021-22 will be a replay of 2011-12

Still Plumbing the Depths

Inflation-linked yields remain at levels never seen before 2020

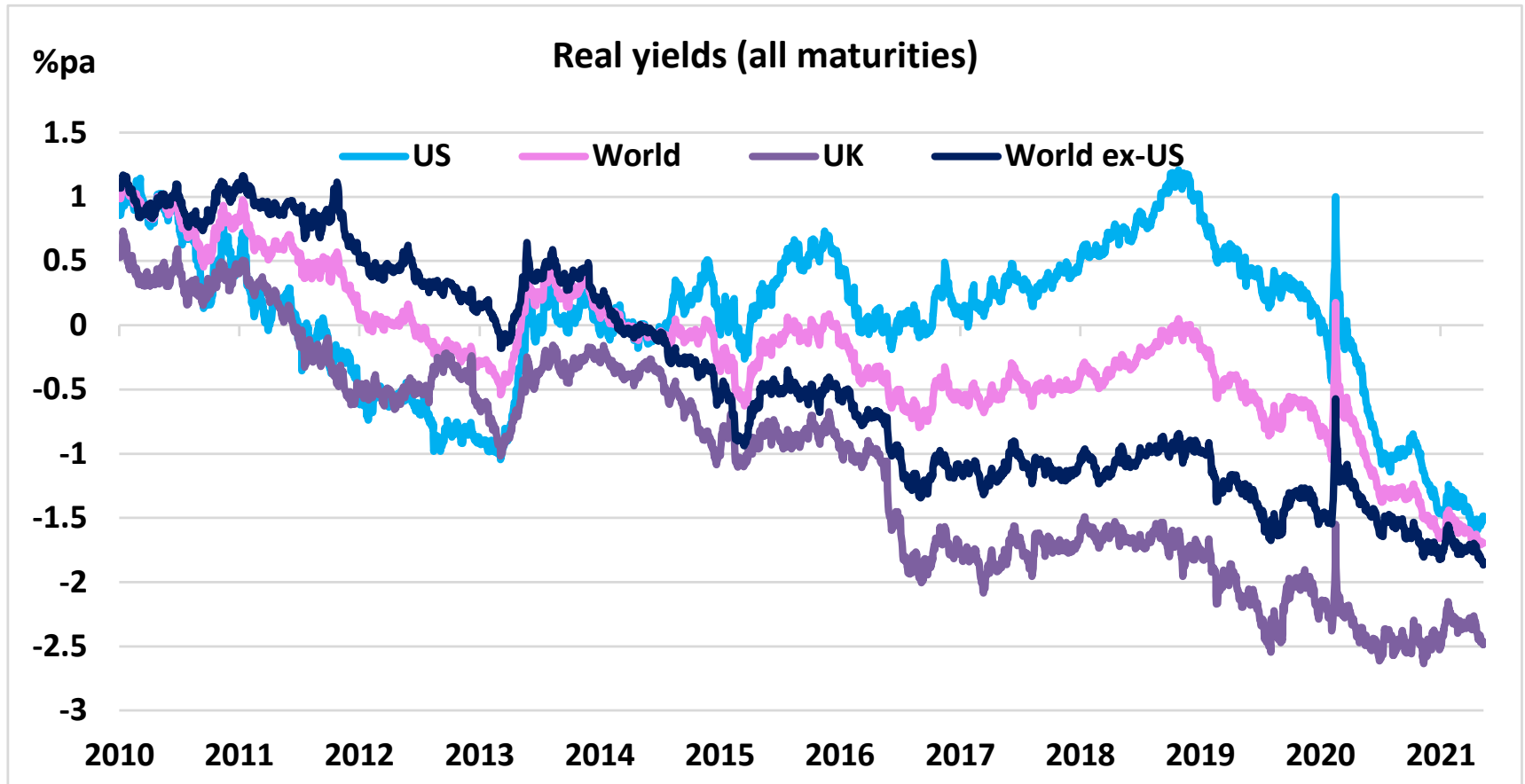
■ US Generic Govt TII 10 Yr - Last Price



Source: Bloomberg

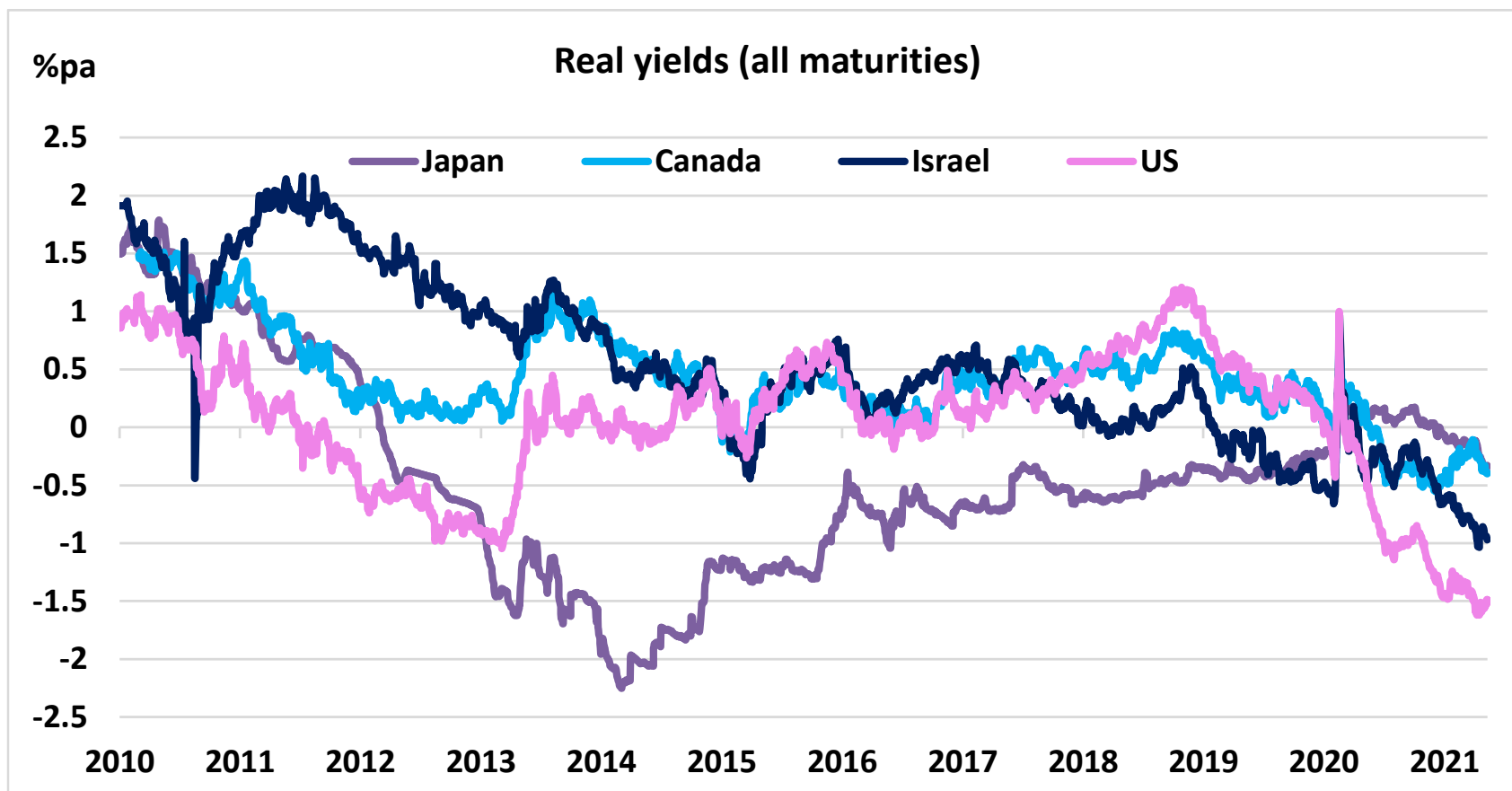
Slide in real yields preceded Covid-19

- Financial repression writ large



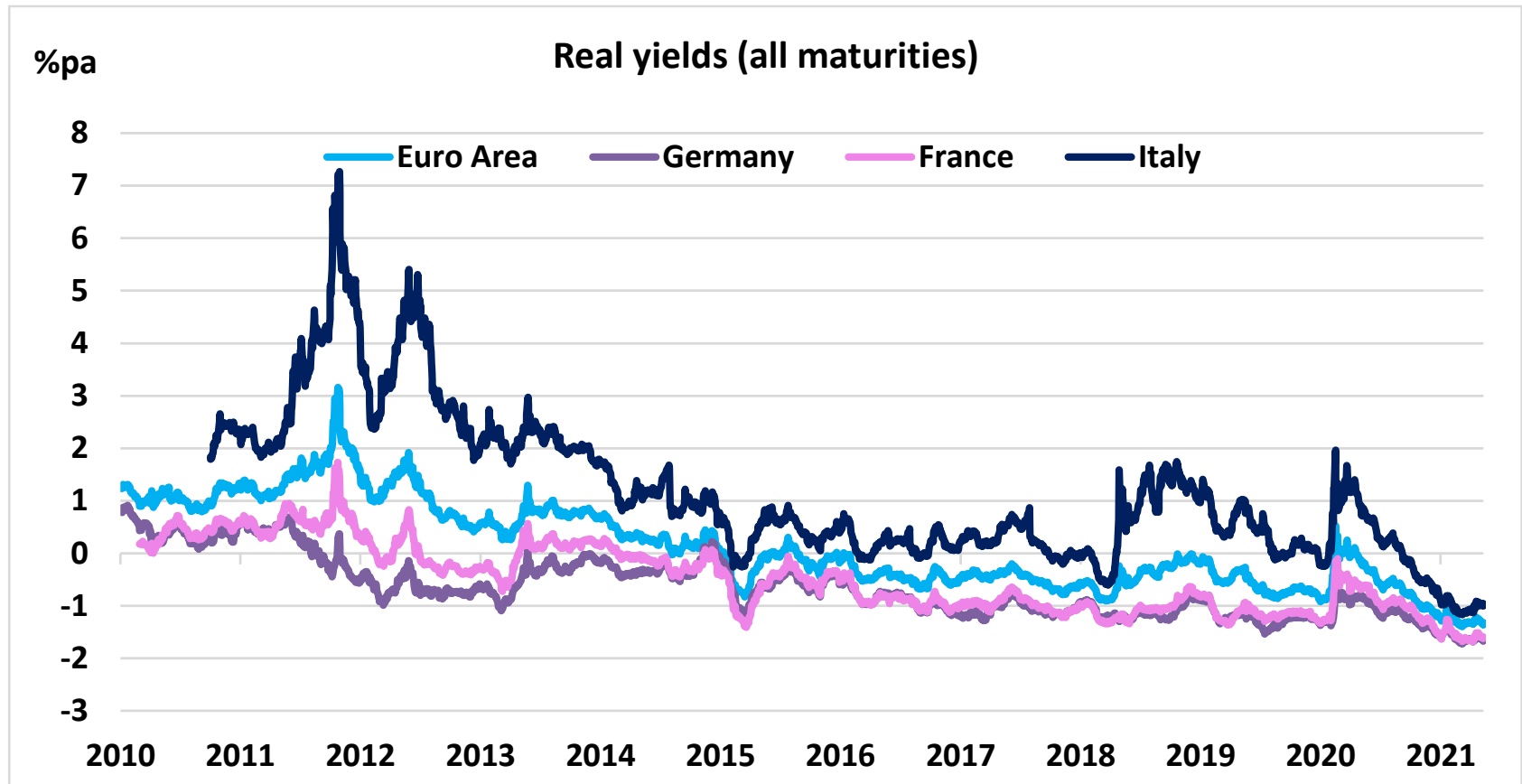
Japan has been swimming against the tide since 2014

- Canada offers a real yield premium over US



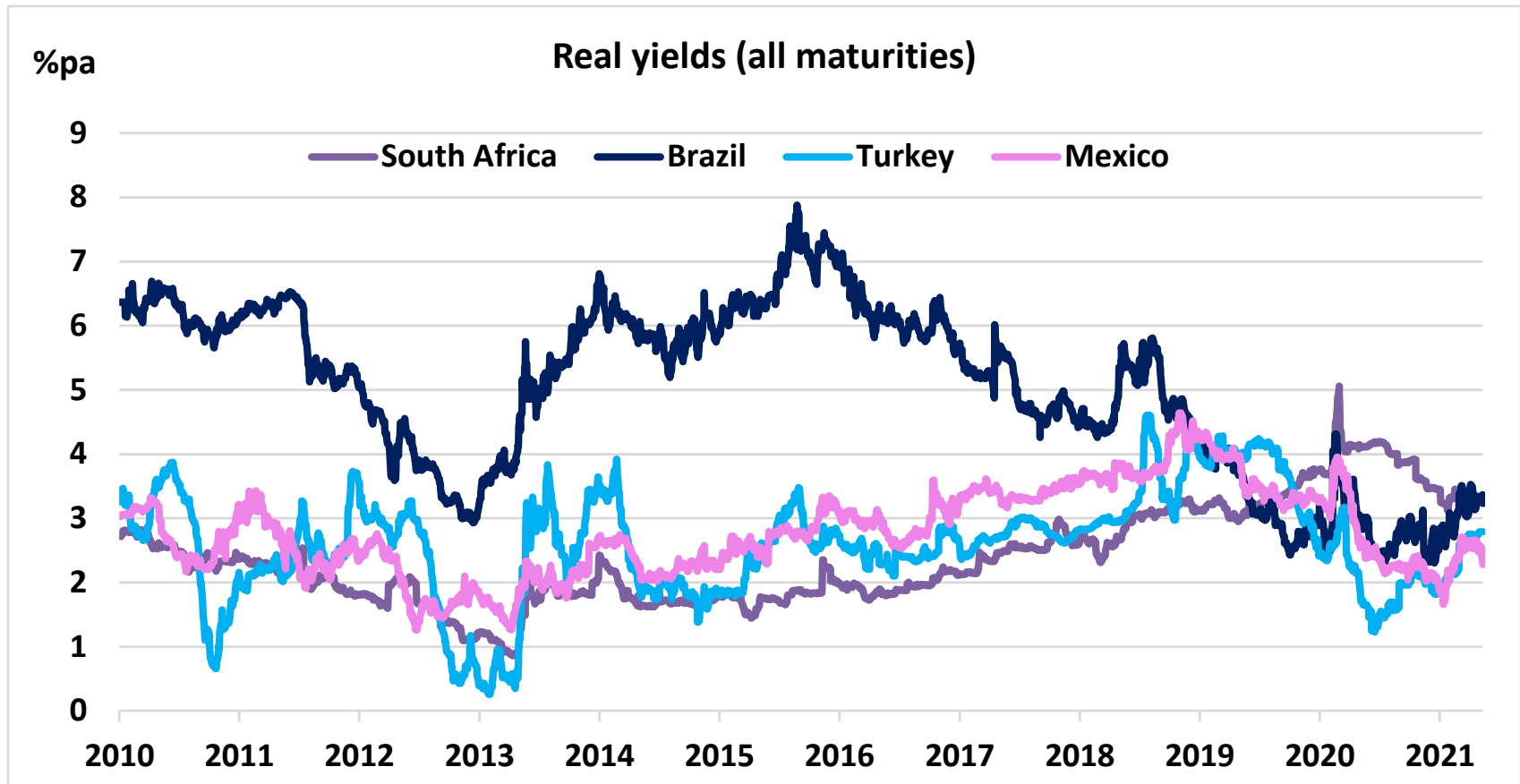
Italy's real yield premium has all but vanished

- The doves are still in charge at the ECB



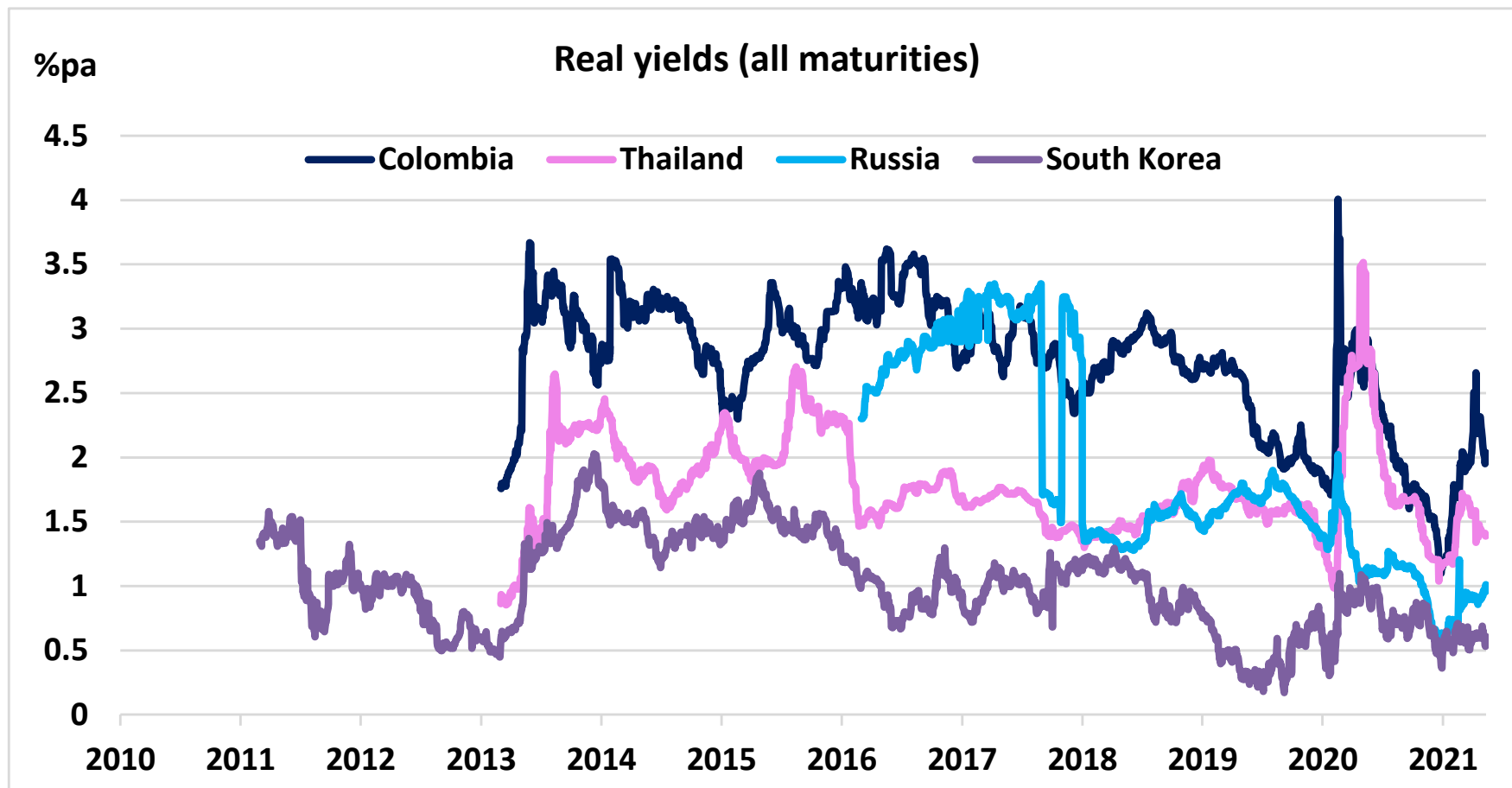
Positive real yields are still available in EM ...

- .. if we can trust the inflation data



For how long will a real yield be available?

- More compression is likely



If real yields head lower, there will be an upheaval



Source: Bloomberg, Morgan Stanley Research. Note: correlation from 2010 onwards. All sectors are based on MSCI ACWI sectors. They use excess returns for credit here.

Beneficiaries of real yield suppression

- Gold versus US Dollar
- Value stocks versus growth stocks
- Dividend paying stocks vs non-payers
- Inflation-linked DM government bonds
- Inflation-linked EM government bonds
- Investment grade debt to high yield debt
- European core bonds versus periphery bonds
- Utility stocks vs financials
- Prime real estate



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