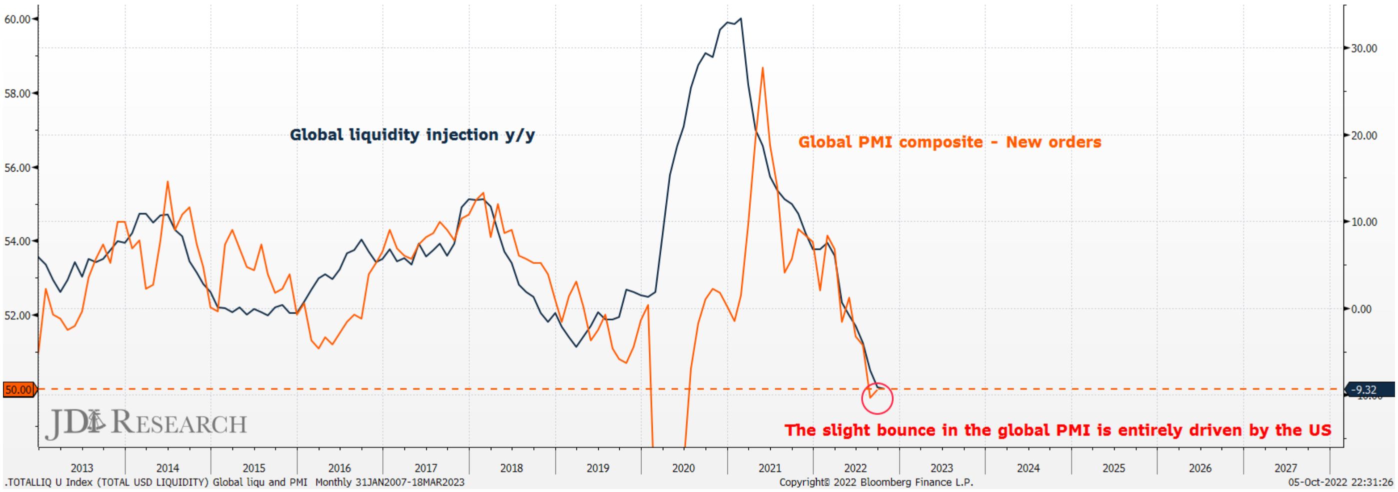
JDI RESEARCH

October 9th, 2022

The USD black hole …

… The energy war is raging with perilous macro ramifications

USD liquidity withdrawal brings global demand to its knees:



- **Short EUR/Gold at 0.575, looking for new lows.**
- **Raise cash levels <u>in USD</u> to be ready to pounce on equities when a permanent fix to the crisis is reluctantly adopted: stealth monetisation.**
- Take profit in short 5yr TIPS from 82bps for an 83bps gain.
- Stopped out of long equities for an overall 5% loss.
- Hold the BTPs/Bunds spread widener from 190bps (+61bps profit).
- Short US 2yr inflation breakevens at 2.30.

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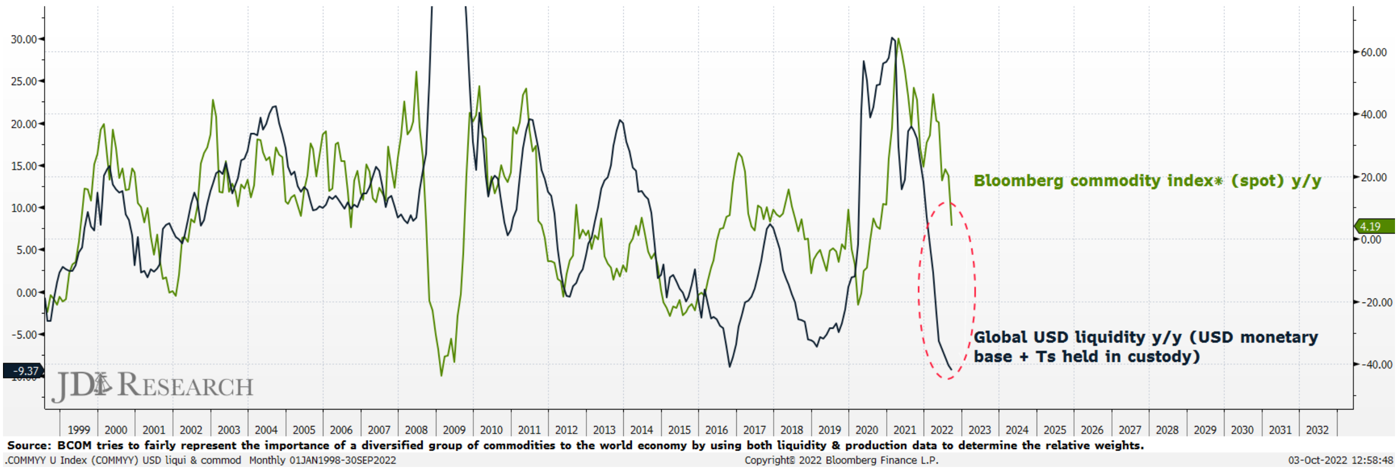
1. The US landing is soft, but it is a hard blow for the Fed

… Lower goods and commodity prices are revitalising US consumption

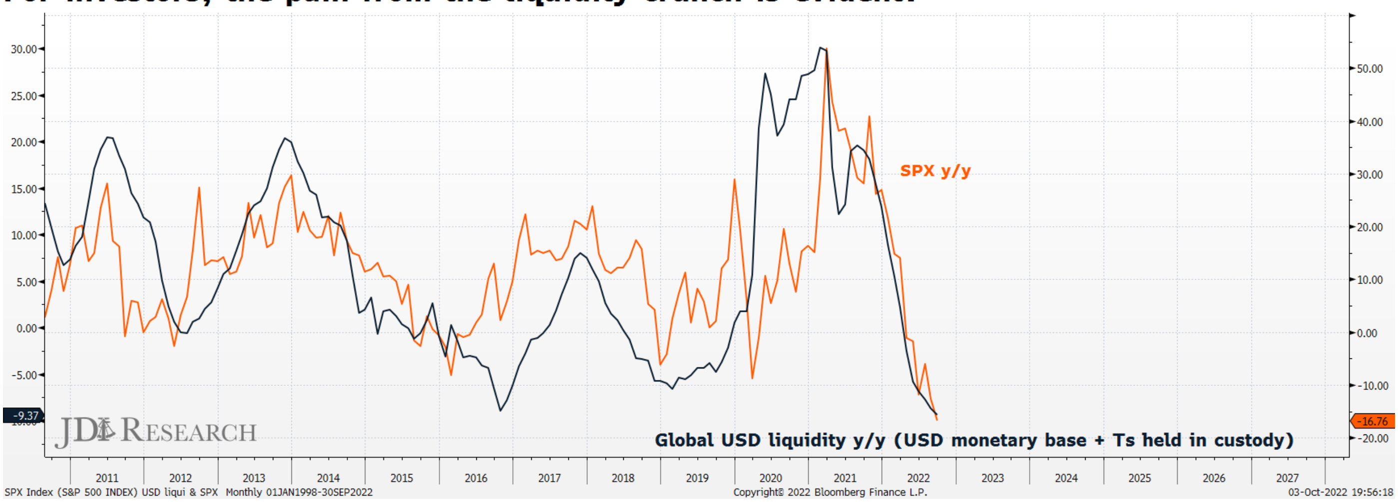
The Fed keeps whacking nails into growth momentum, and cracks are appearing. But they are only hairline fractures -- not the fissures many bears are touting. The economy is still running too hot for domestic inflation to cool, so the Fed keeps shrinking global USD liquidity. However, a raging global commodity war is limiting the disinflation a dollar crunch would normally cause so **instead of an adjustment, a financial crisis looms:**

The USD liquidity crunch is less disinflationary than normal due to supply constraints ...
... A continued focus on fast disinflation now risks a financial crisis:



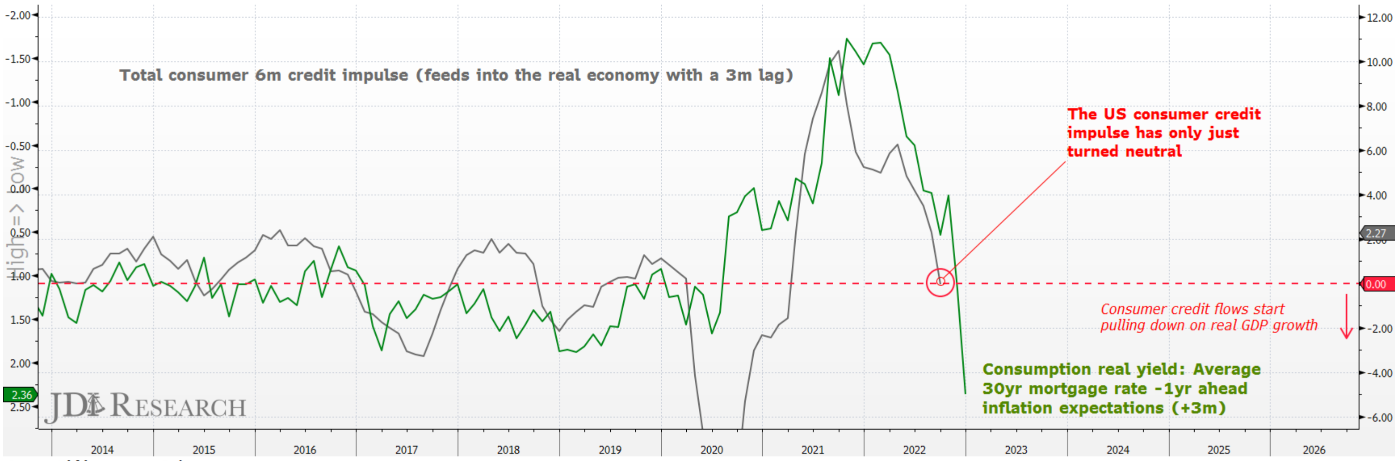
While the liquidity crunch still struggles to kill inflation, it has been lethal for investors:

For investors, the pain from the liquidity crunch is evident:



And as those investors fall by the wayside, we (and the Fed) still hold out for the white flag from consumers. Only their capitulation will curb inflation and stabilize US yields and financial conditions. But it is a long time coming:

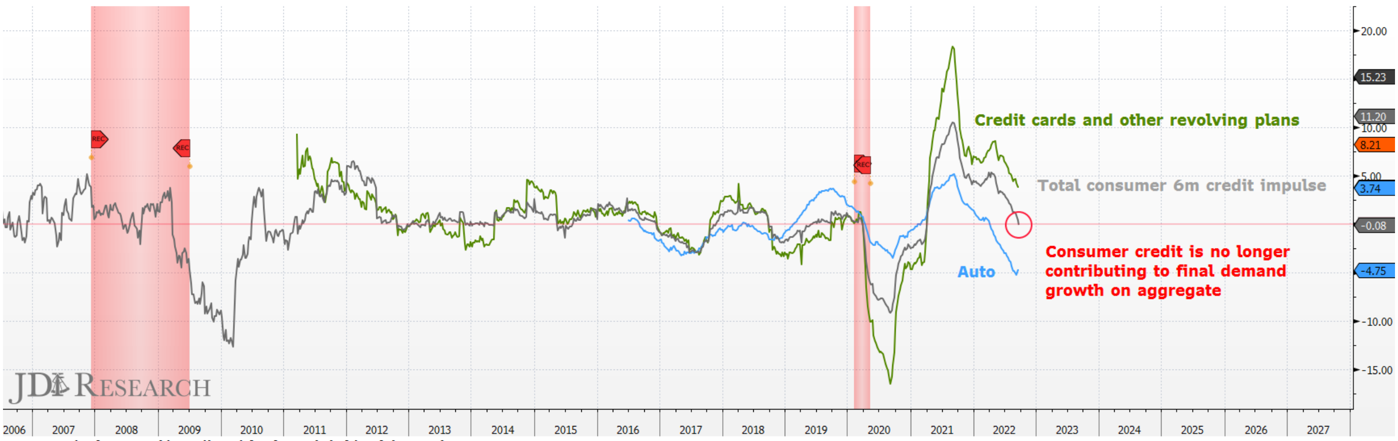
The consumer's credit impulse has only just turned neutral ...
... Historically, the Fed has not made a dovish U-turn before the credit impulse turned deeply negative:



Source: Michigan survey, Fed
NAPMPMI Index (ISM Manufacturing PMI SA) Cust & Real Estate imp Monthly 29FEB2000-31MAR2023 Copyright© 2022 Bloomberg Finance L.P. 03-Oct-2022 11:51:58

Sure, the Fed has won a few battles, but it hasn't won the war. The US consumer credit impulse finally reverted to neutral in September (chart above), so **household leverage is no longer feeding into final domestic demand growth** (with a 3m lag). The auto sector's mean reversion is largely to thank for that; consumers are yet to turn their back on credit cards and other revolving plans:

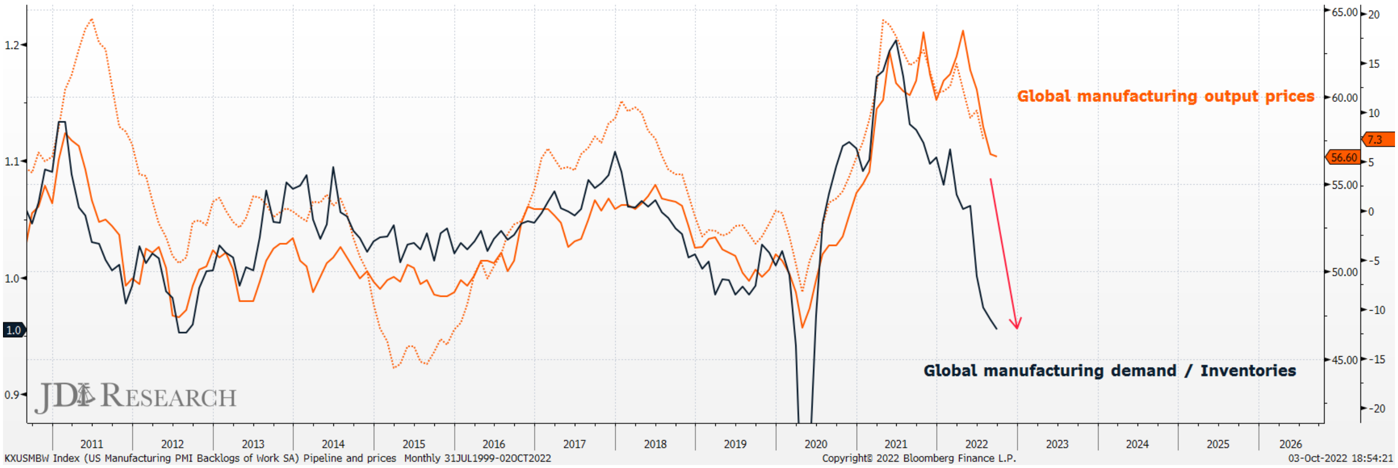
The consumer credit impulse has only just turned neutral ...
... With consumer credit ex auto still disturbingly strong:



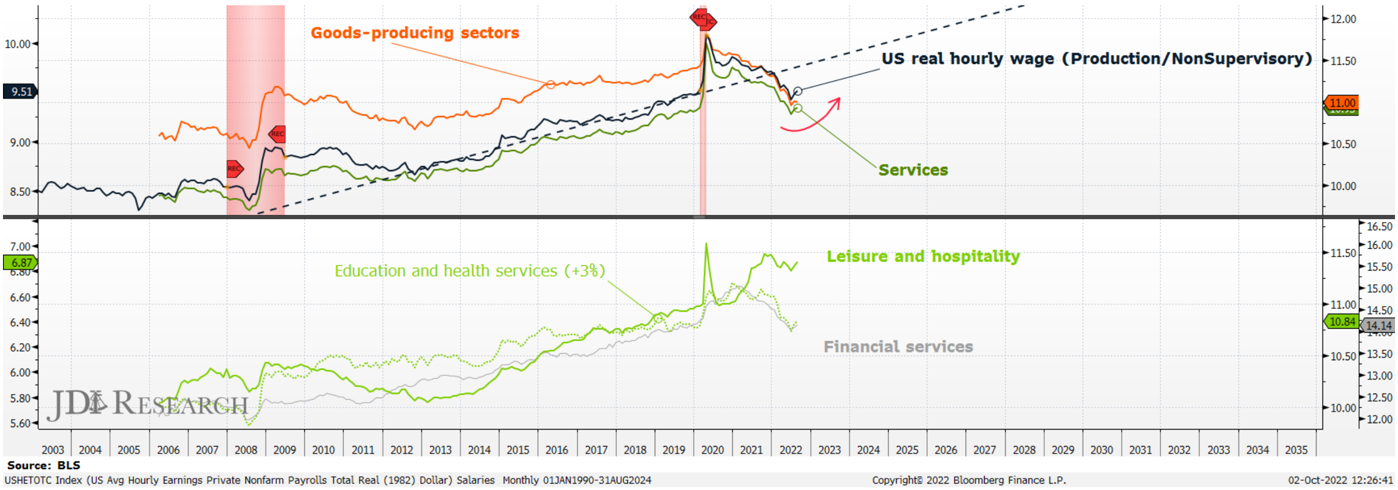
Source: Federal Reserve (data adjusted for the statistical break in 2010)
.CREDITDA U Index (CREDITDA) US credit data adjuste2 Daily 04AUG2004-02OCT2022 Copyright© 2022 Bloomberg Finance L.P. 02-Oct-2022 15:25:04

Alongside the credit impulse, the labour market kettle keeps whistling: job opportunities are strong, and wages rising. Worryingly, **signs suggest global disinflation is releasing purchasing power gains for the US consumer** – whose animal spirit is evidently still alive and kicking.

The deep global deflationary supply/demand goods imbalance is worsening ...
... And taking its toll on global manufacturing prices (although arguably prices are sticky):



One person's poison is another's food ...
... Heavy global disinflationary forces combine with strong US reflationary pressures to finally turn real wages around:

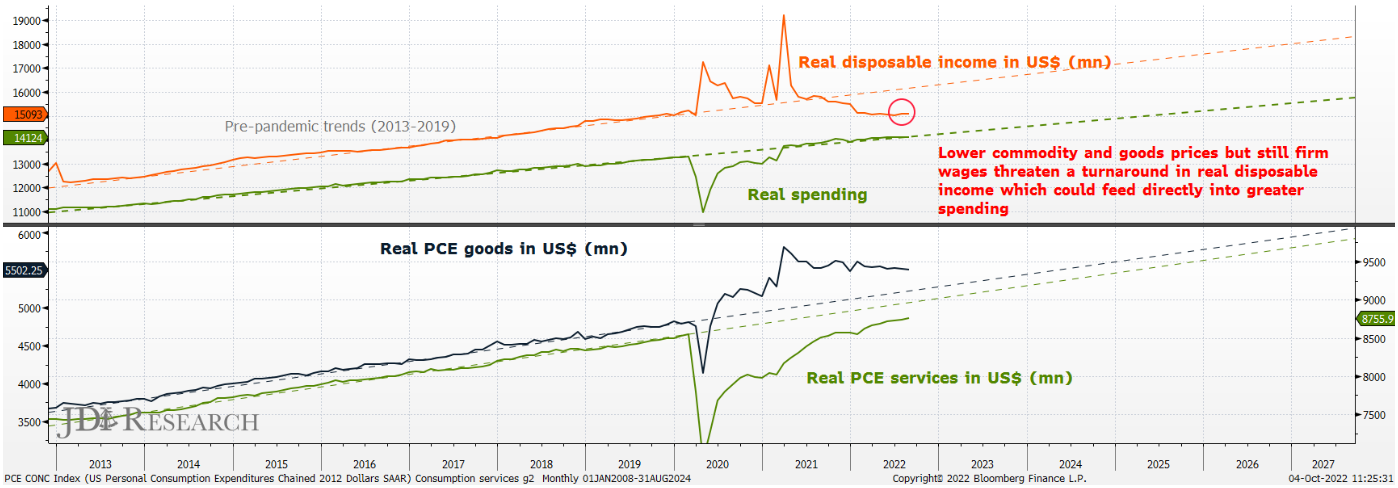


This is a headache for the Fed: if the labour market refuses to roll over, lower goods and commodity prices may breathe new life into the American consumer.

On Oct 3rd, New York Fed Williams said inflation was [like an onion with three distinct layers](). On the outside you have globally traded commodities (lumber, steel, grains, and oil). Cut into the middle and you find goods. And the core? There you have underlying inflation, reflecting the economy's overall supply-demand balance. Williams fears lower commodity prices and recovering supply chains alone cannot return inflation to the Fed's 2% target. Domestic demand for durable goods remains too strong, and the demand for labour and services still far outstrips available supply. **I would go one step further and argue that lower commodity and goods inflation could help revitalize the US economy and keep services inflation on a roll.** So, if your eyes aren't watering yet, they should be.

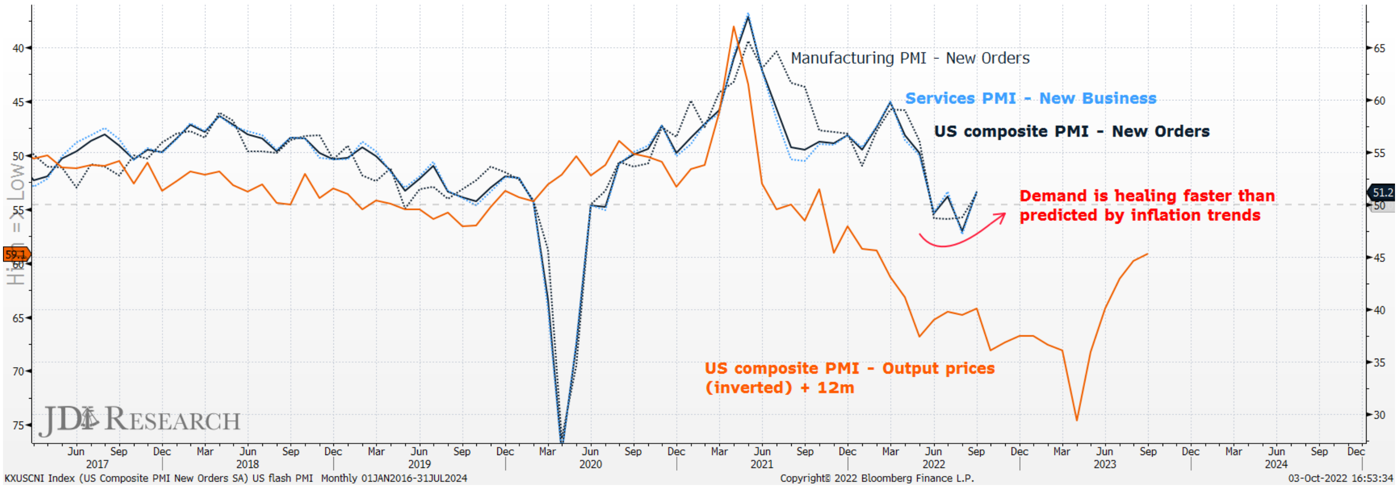
- In August, the **Commerce Department report** showed real spending was still batting away the challenges of rising inflation and interest rates. **Consumers'** pandemic binge on durable goods is also lasting longer than expected despite an ongoing shift towards services. **In future, rising disposable income may replace leverage as a source of real spending on services:**

Real spending remains resilient...
... And the improvement in real disposable income will continue to support real consumption:



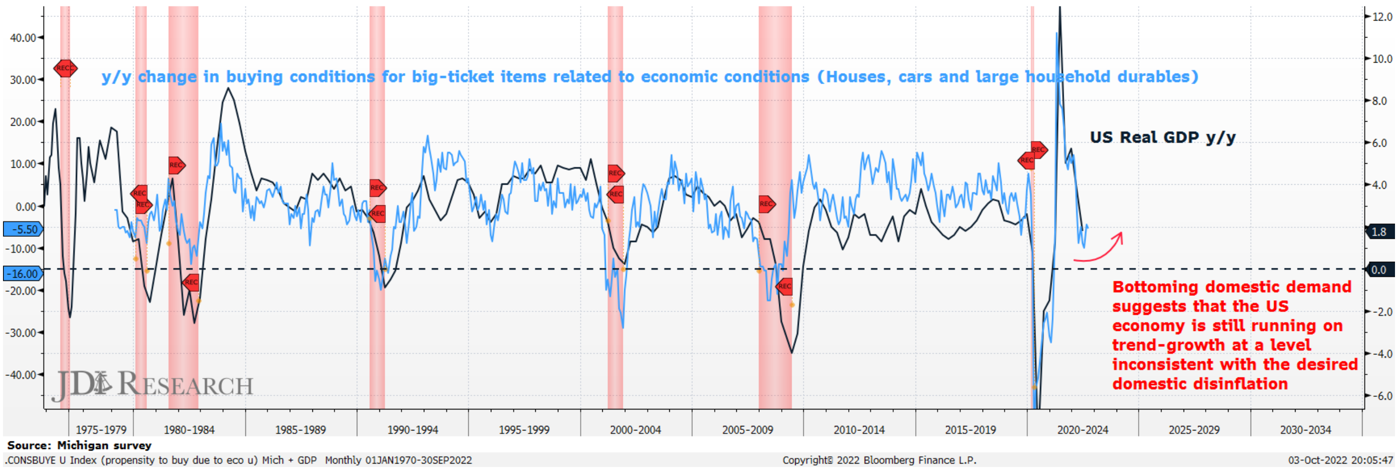
- In the same vein, the latest PMI surveys show US final demand already bottoming – way earlier than in past bouts of inflation. This suggests that the **demand destruction caused by the recent inflation and interest-rate shock is only tentative:**

In the US, disinflation is already stabilizing demand ...
... Despite higher borrowing rates, a consumer-led recession is not yet a done deal:



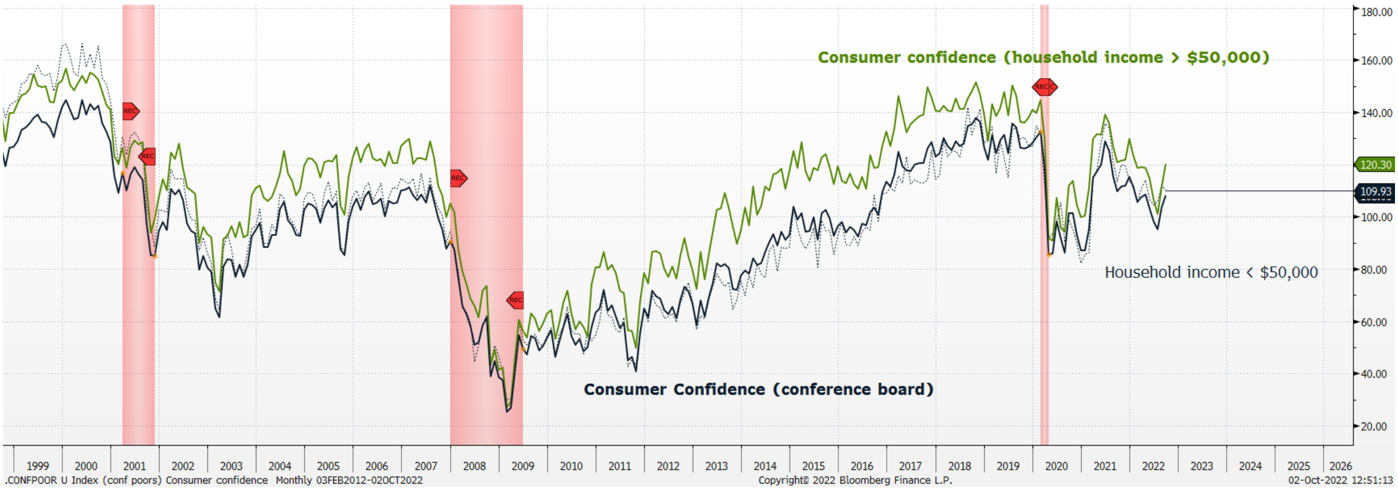
- September's **Michigan survey** also suggests a budding second wind in purchasing intentions and an economy still running near trend growth – a level inconsistent with the desired domestic disinflation:

Surging prices and borrowing rates are insufficient to curb demand ...
... The strong job market and budding disinflation trends are already allowing domestic demand a second wind:



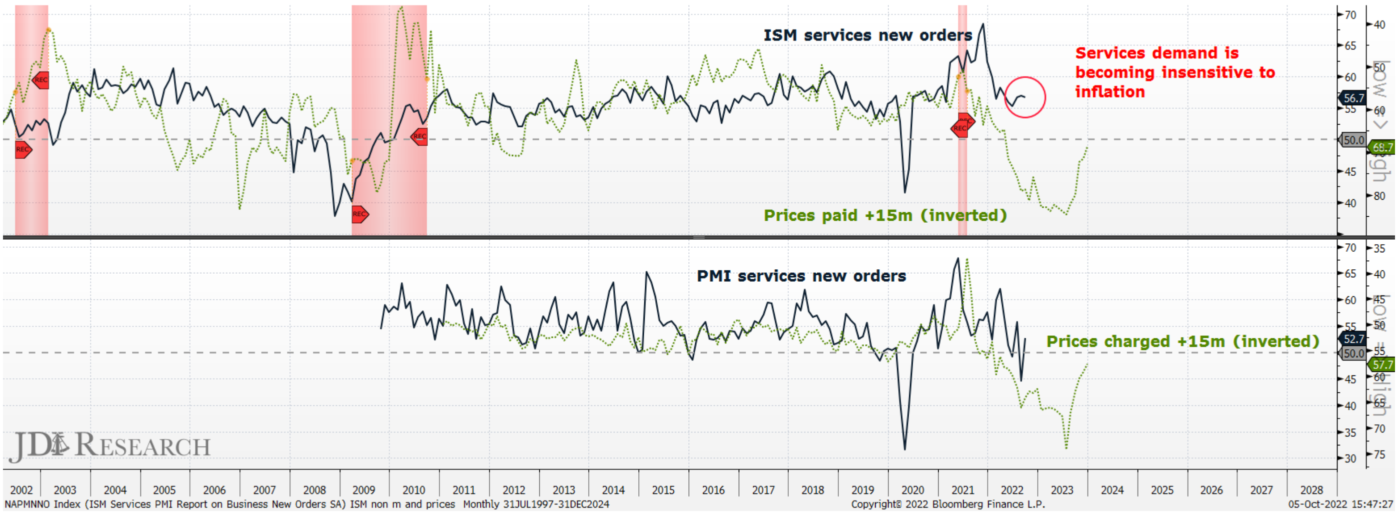
The **Conference Board** survey concludes likewise: *"consumer confidence improved in September for the second consecutive month supported by jobs, wages and declining gas prices":*

Despite powerful negative wealth effects, higher prices and higher rates ...
... Confidence is bouncing up on lower gas prices and a strong labour market:



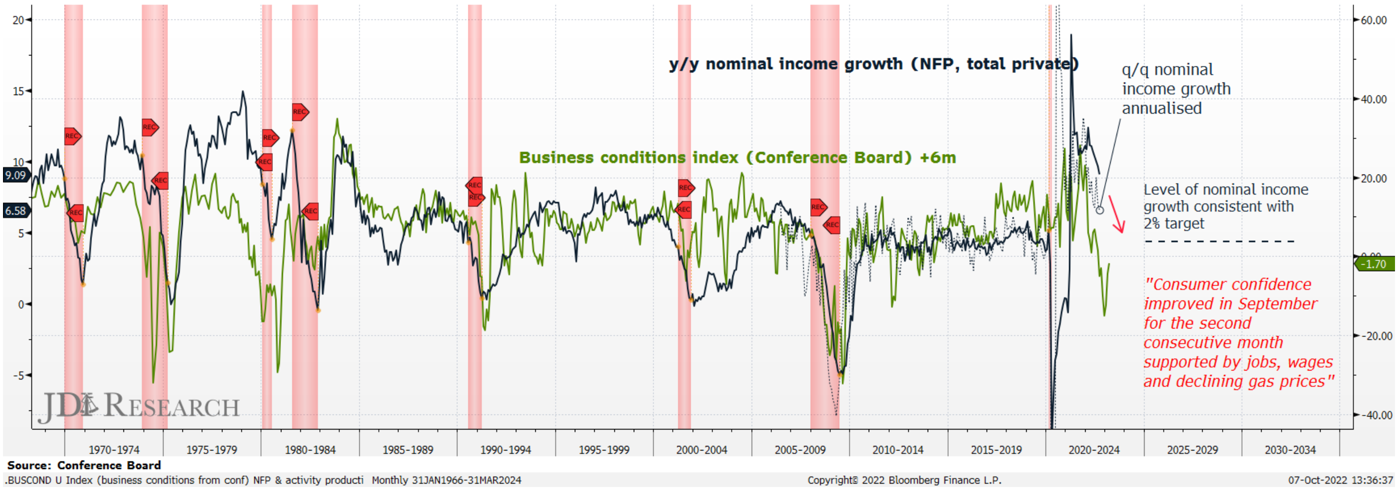
- In the last JDI report, the divergence between the **ISM and PMI** services surveys kept us guessing. But this month, both forward demand components are back in line and touting a simple message: **services demand is losing price sensitivity.** Sadly, supply/demand rebalancing is still a long way off for services, implying purchasing power gains in the goods/commodity sector are spilling over:

The US services sector is becoming less and less price sensitive:



In the US, the sky is brightening too fast. Last Friday's NFP release showed the labour market is still growing at 6.58% q/q annualized (from 7% in August) – way above the 4% that would be consistent with the Fed's 2% inflation target:

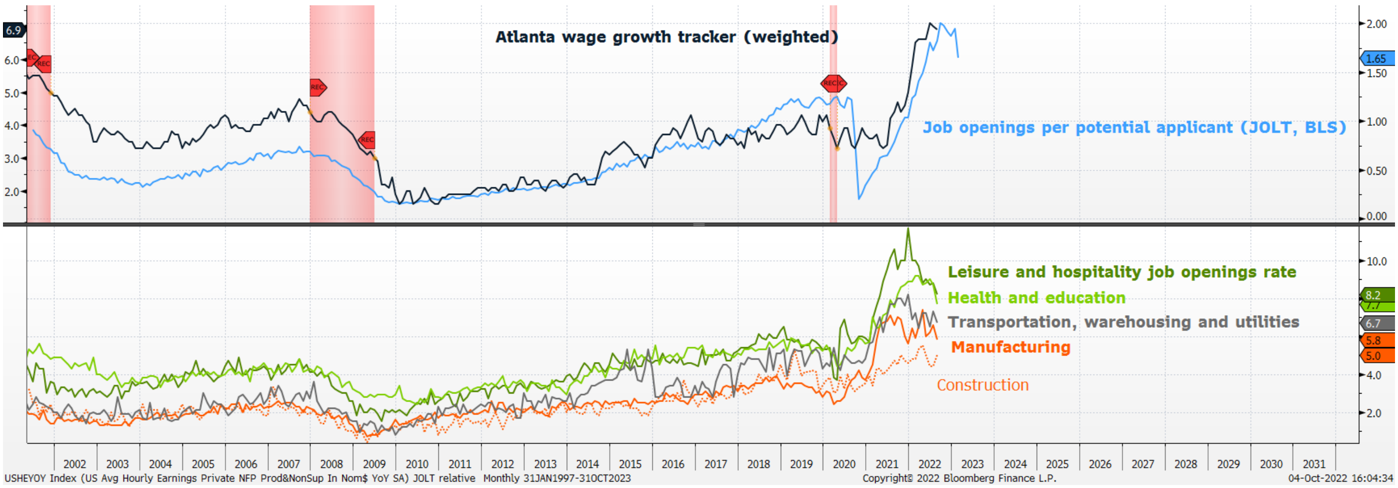
Confidence is recovering on lower global prices but strong domestic conditions ...
"Inflation and interest-rate hikes remain strong headwinds but concerns about inflation are at the low of 2002"



So, although the Fed has opened a few cracks in the economy, green shoots are growing through them. Investors are suffering hefty financial losses, but consumers already show signs of healing. **Importantly for our strategy, the Fed's economic pain tolerance is untested.**

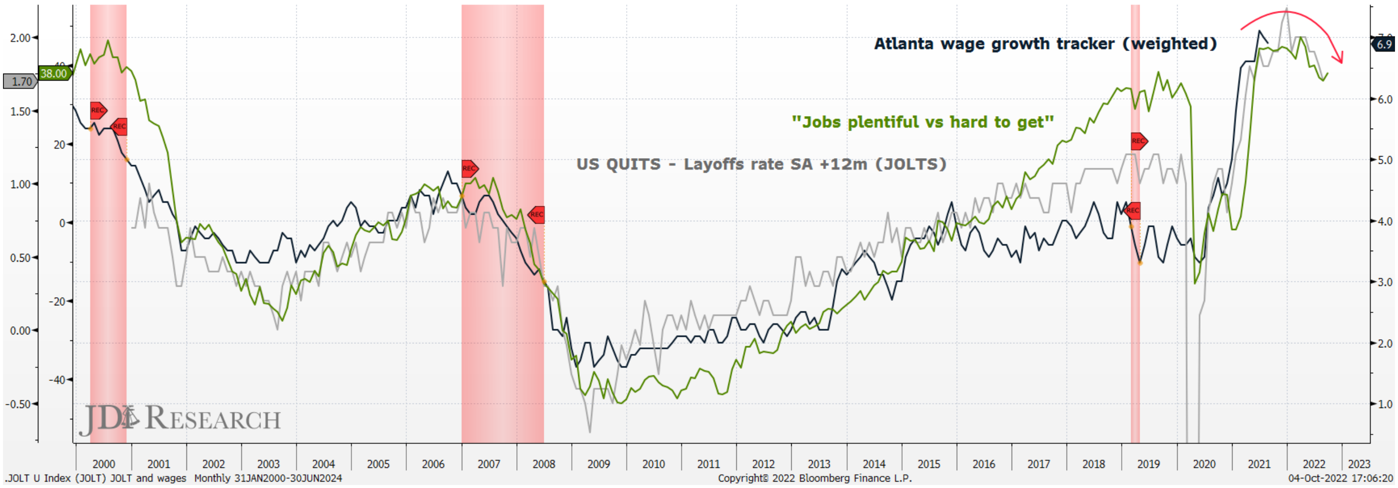
The FOMC will breathe a sigh of relief after the August **JOLTS report** showed the ratio of job openings per potential applicant fell from 2 to 1.65:

The ratio of job openings to applicants fell in August ...
... The Fed can breathe a sigh of relief, labour demand remains strong but it is now headed in the right direction:



Workers' bargaining power also softened further in August. The quits rate stabilized as layoffs inched up for the first time since January 2022:

Workers' bargaining power is at a peak ...
... But will be slow to soften meaningfully:

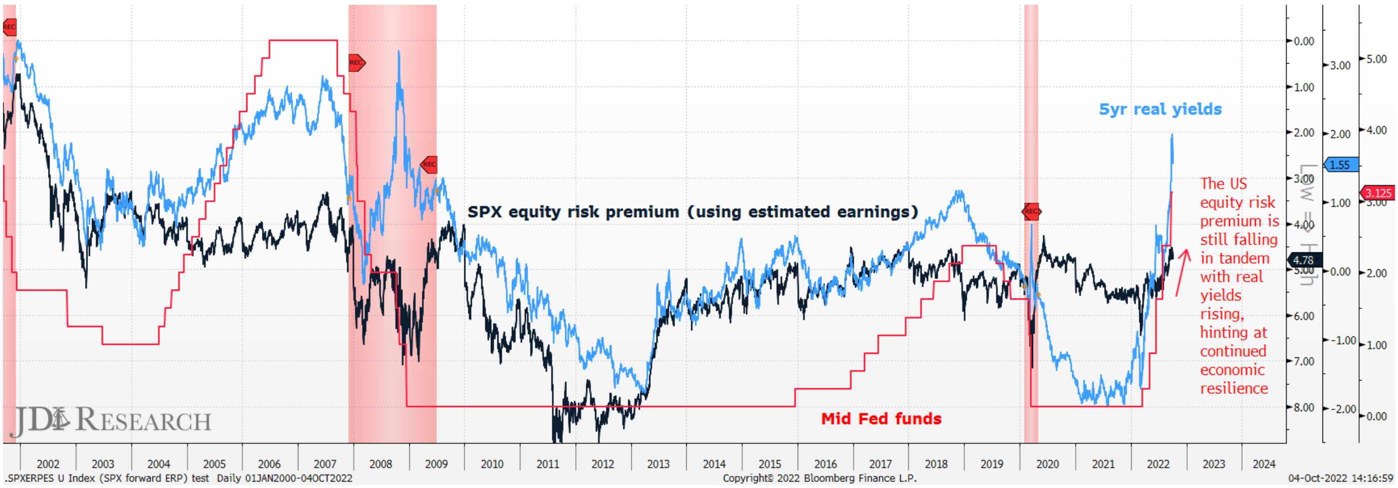


Don't get carried away, though. We are still talking about a strong labour market normalizing after the post-pandemic bullwhip **-- we are not talking about a hard landing.** The total working-age population is growing by 150,000-175,000 per month, and monthly job gains above that number will keep driving unemployment lower. You would need several months of NFP growth well below 150,000 to make the Fed even consider pausing before 4.5%. Well, assuming it can remain solely focused on its domestic mandate…

Turning to equity markets for a further hint on US economic health, my narrative is unchanged: a strong economy has depressed US stock prices due to the Fed aggression. But an imminent recession necessitating a Fed pivot still appears a remote prospect.

- **The S&P 500 forward Equity Risk Premium** (measured at the distance between the S&P 500 12-month forward earnings yield and the 10yr TIPS yield) has declined continuously since the heights of the pandemic despite acute geopolitical risks. I think that reflects a much stronger medium-term economic backdrop of structurally stronger demand due to higher wages, robust fiscal spending, higher structural inflation, baby boomer dissaving, and higher investment:

US equity risk premia are still falling ...
... Highlighting 1) extreme valuation or 2) that the US economy is strong enough to take higher real yields in its stride:

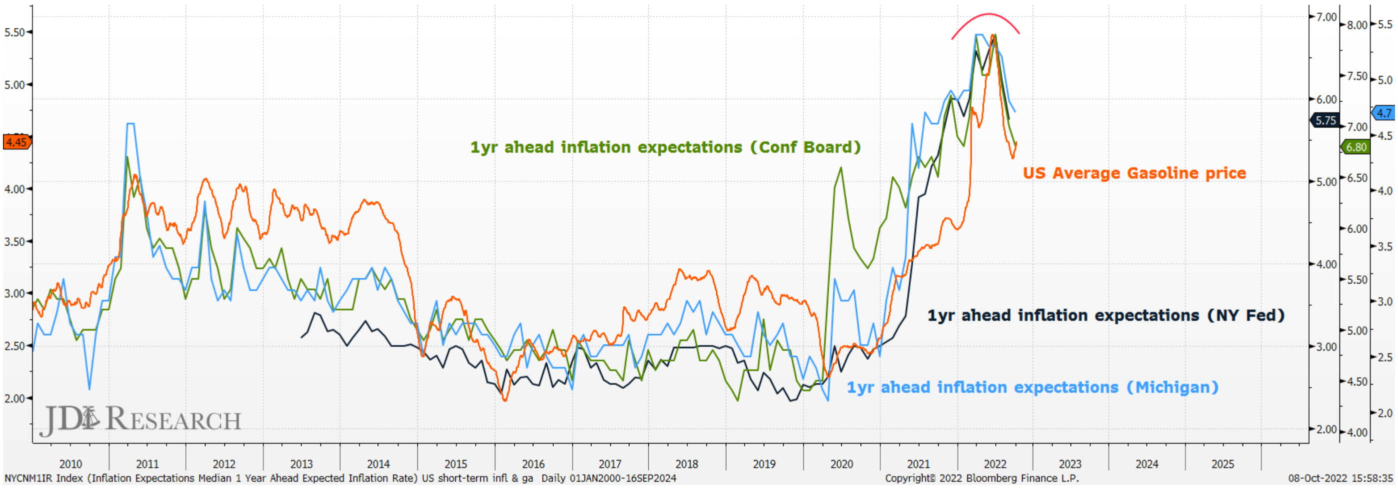


- **I also find IWM/TLT a neat nominal growth coincident indicator** (IWM is the Russell 2000 "domestic" ETF index, and TLT is a US treasury ETF) and **useful gauge for medium-term nominal yields.** Again, unlike in 2018, the ratio has been climbing to date and remains near post-pandemic highs. That suggests the current nominal yield level is easily bearable, at least for the US economy:

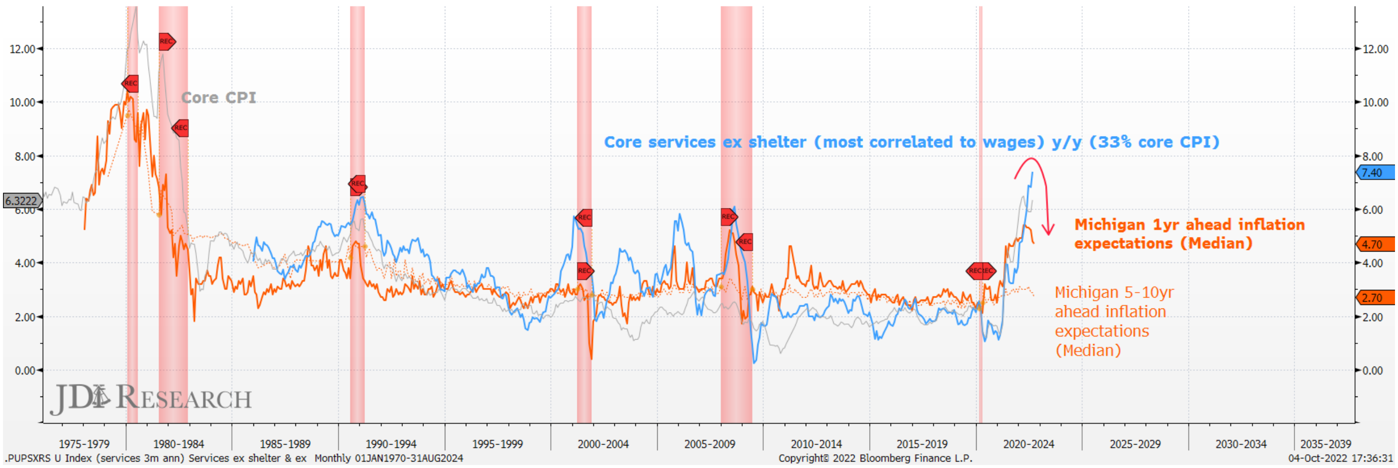
The nominal growth discounted by stocks remains strong ...
... Suggesting room for higher nominal yields still:

I conclude that **the US economy remains in soft landing mode and that the Fed has no reason to deviate from its forward guidance**. Short-term inflation expectations – likely to drive core services inflation – are still too high to allow hope of a quick turnaround in underlying domestic inflation. And this week's OPEC+ effort to support oil prices will further slow the normalization of inflation expectations:

Inflation expectations are coming down, lowering the incentive to demand wage growth ...
... But it remains a slow process:

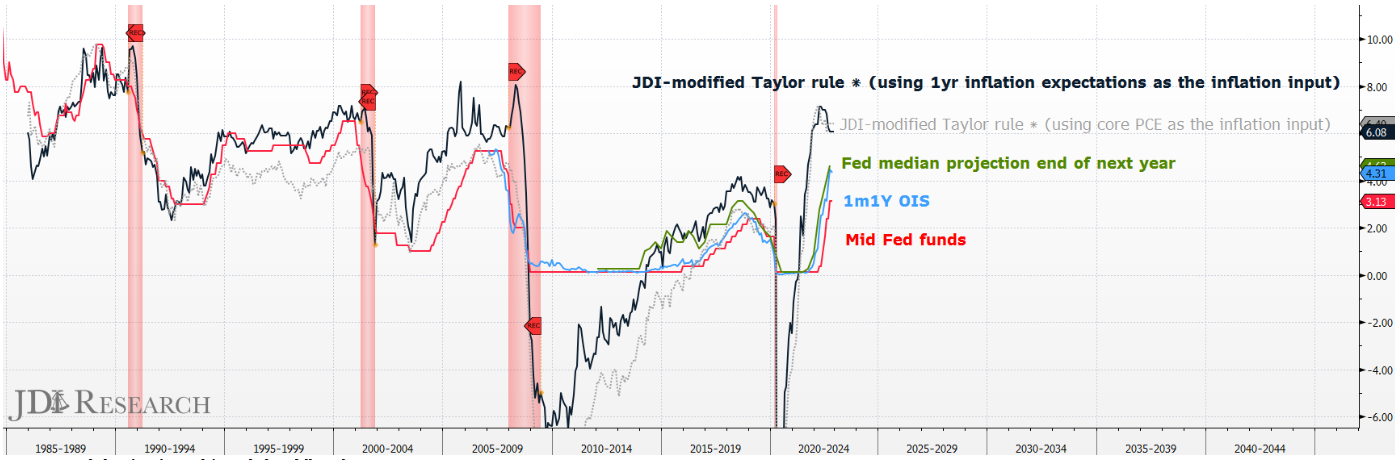


The stickiest CPIX component will be core services ex shelter (33% CPIX) ...
... It is a function of both labour market tightness and inflation expectations:



Past recessions happened when the Fed funds rate (FFR) approached our modified Taylor rule (the most dovish one, ignoring labour slack at full employment). We have introduced 1yr inflation expectations as the inflation input for a forward-looking bias. At around a 4.5% terminal FFR, we are nowhere close; the rule suggests above 6%. Of course, the Fed hopes – as I do – that short-term inflation expectations will normalize, allowing the Taylor rule to converge to 4.5%. But there is little room to manoeuvre here. The Fed must stand firm on its resolve to return inflation to target.

The issue if inflation expectations do not fall faster …
… Is that the most dovish Taylor rule prescribes a terminal rate above 6pct:



Source: * Both functions ignore labour slack at full employment
.TAYLORJD U Index (TAYLORJD) JDI mod Taylor rule Monthly 01JAN1984-31DEC2023 Copyright© 2022 Bloomberg Finance L.P. 03-Oct-2022 16:50:33

2. My power is your poison…

… A thriving US forces the RoW to choose inflation or deflationary depression

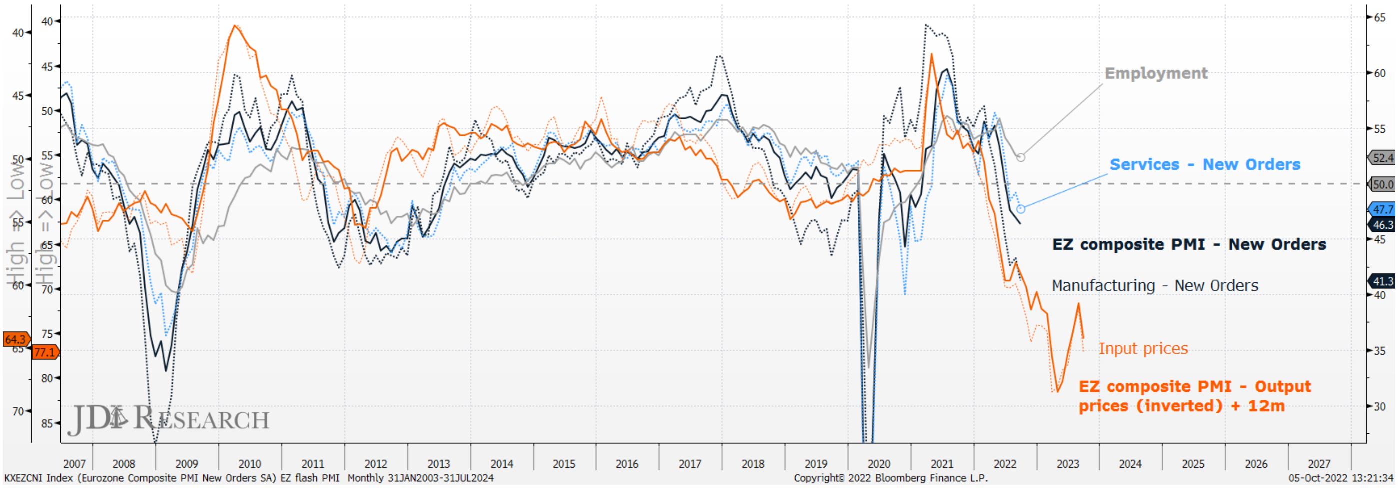
<u>The game changer since the last JDI report:</u>

In the last report, I speculated that geopolitical tensions may ease and that converging interests this winter may force Europe and Russia to negotiate a settlement. Under economic duress, Europe would turn a blind eye to Putin's illegal annexation of the four Russian-occupied territories in Ukraine. Meanwhile, Russia would declare "victory" to save face at home. With the Nord Stream sabotage, that ship has now sailed.

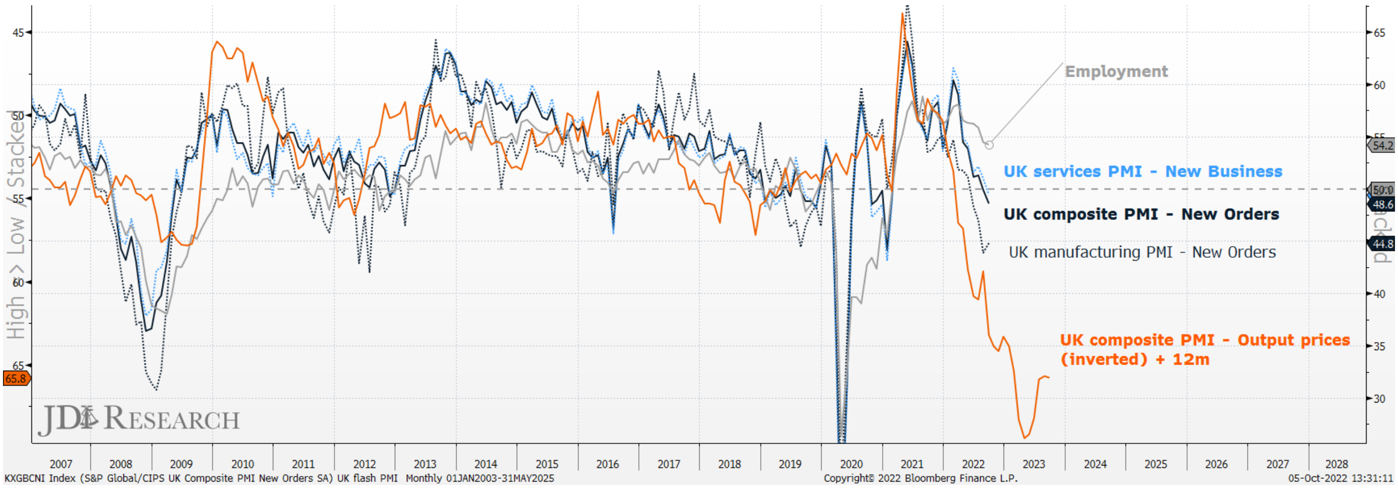
In higher spheres, the invasion of Ukraine is considered a tremendous opportunity to disarm Russia in a raging economic war where Putin's ace in the hole was the weaponization of energy. Did the world's police permanently sabotage those pipelines to remove Putin's leverage over Europe? **Whoever the culprit was dimmed the light on any chance of a quick resolution to the European energy crisis** and on a V-shaped recovery from the recent slowdown. The good news is that

Putin has lost his leverage over Europe. **The bad news is the price we paid: the European energy crisis turning chronic – with the US now in full control.** For the first time since March, cost pressures have intensified, collapsing leading indicators to new lows in September.

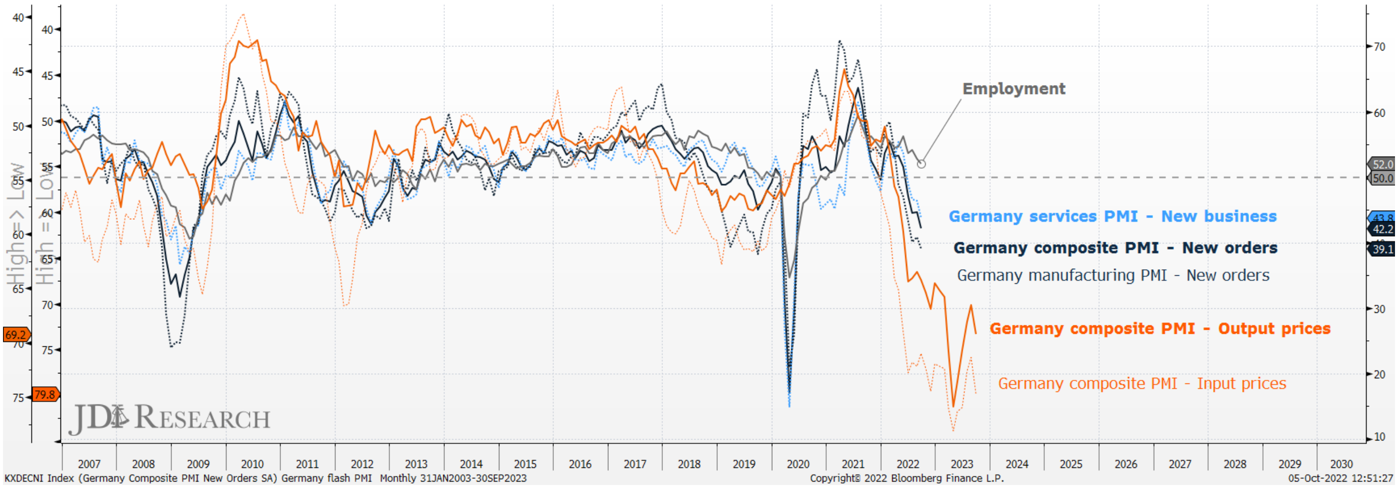
In the Eurozone, soaring energy costs, rising uncertainty and weakening demand ...
... are all contributing to collapse business confidence to its lowest level since the first Covid wave in 2020:



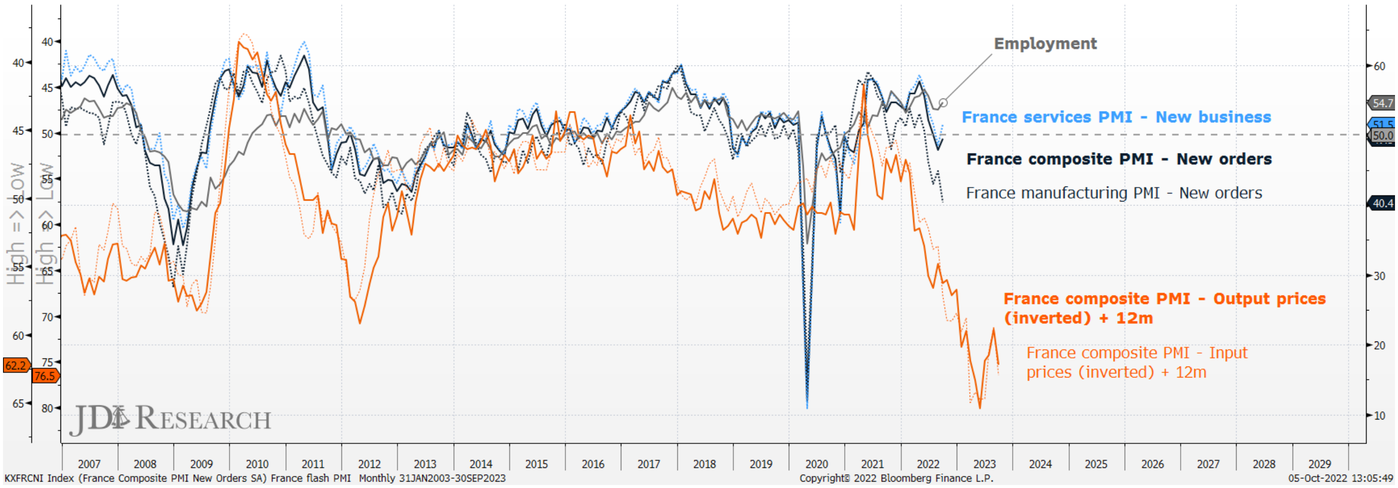
In UK, the services sector is stalling ...
... Following manufacturing into a considerable downturn:



In Germany, business expectations dropped to their lowest since May 2020 ...
... And employment growth was the lowest in 19 months:



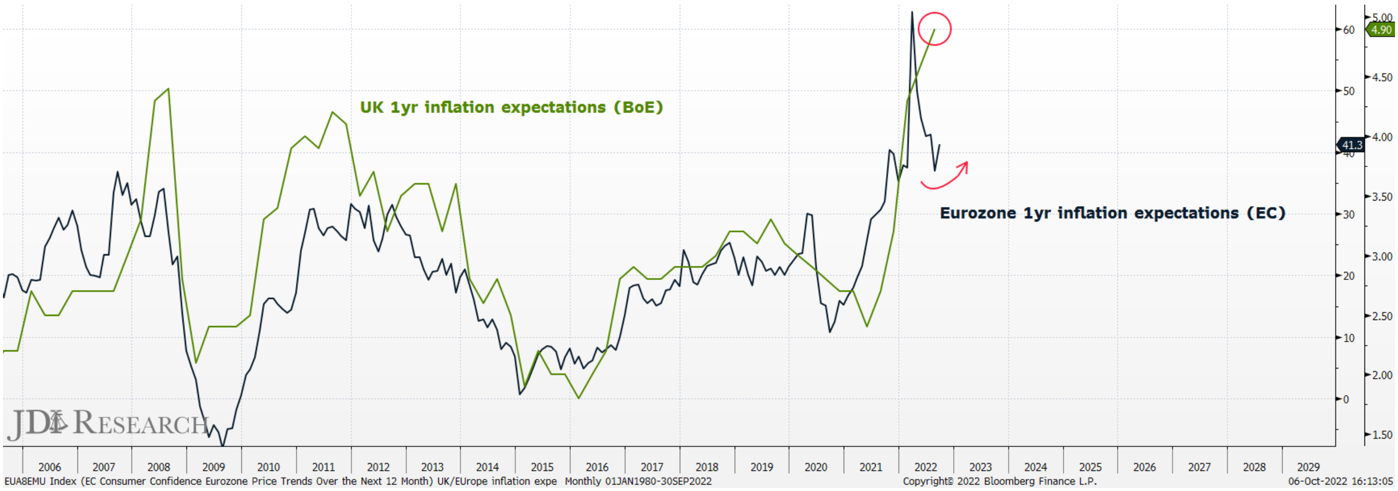
In France, where the consumer is shielded from rocketing energy prices since day 1 ...
... Services is holding up and people have jobs. But those are the only good news:



Now the economic backdrop has become desperate, fiscal authorities are rightly back on deck. After all, we are once again at war.

Unlike during the pandemic, though, inflationary pressures are intense, notably in the UK. This week, a BoE business survey showed year-ahead consumer inflation expectations rose from 8.4% to 9.5% and have yet to peak:

UK/Europe inflation expectations are running stubbornly high ...
... UK expectations are yet to peak and EZ inflation expectations are peaking up again in September:



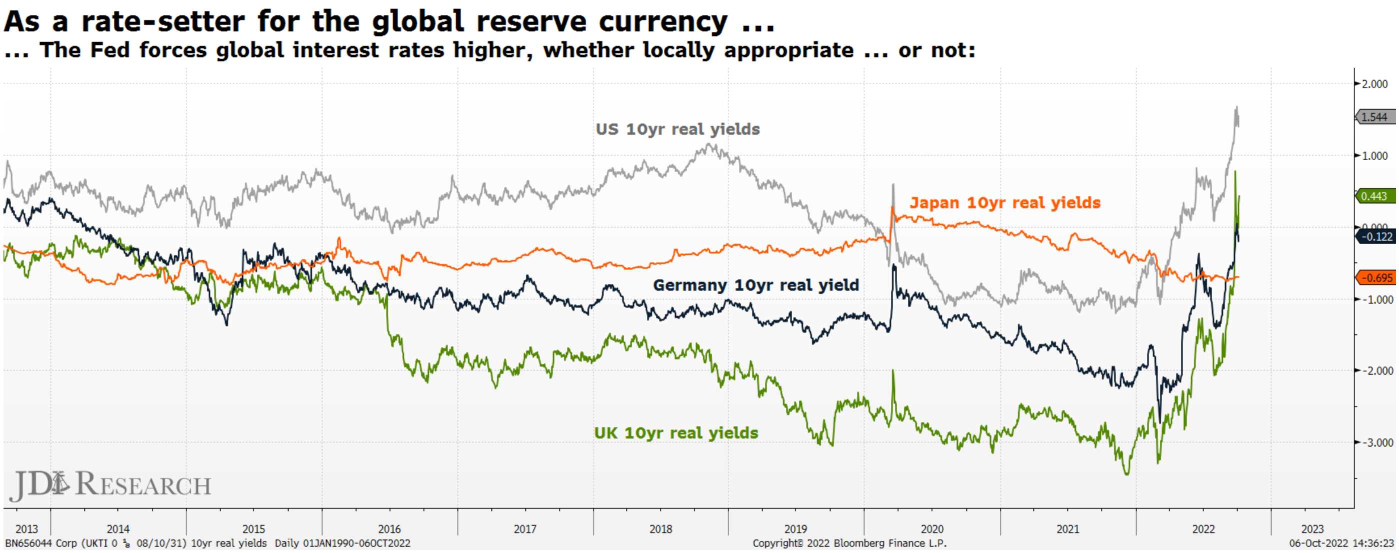
In an economy already running at full capacity and suffering high inflation expectations, debt-financed government spending is a problem. Borrowing yields will automatically adjust, causing the initial public spending to crowd out private consumption and private investment. This would normally be FX positive.

The UK just exemplified this macro dynamic spectacularly:

Its Energy Price Guarantee program was designed to cap the impact of higher energy prices on the UK economy. Worth an estimated minimum of £60bn (depending on future natural gas prices), and combined with £45bn of tax cuts from the new Chancellor's uncosted 'mini-budget', it caused a rate shock that now threatens to undo the tax plan's positive impact on growth. Mortgage rates are rising, and at least 20% of outstanding mortgages face a reset over the next year. With inflation and record-tight global liquidity conditions, there is no fiscal free lunch.

The chaos forced the Bank of England (BoE) to pivot. It renounced QT and returned to QE until 14 October to avert a liquidity-driven mass bankruptcy of the UK pension system. But the BoE's move is a band-aid, not a cure: a return to free markets means gilts will again face a potential cliff edge. **How long will it take to realize interest rates need permanently capping for the country to escape a deep recession?**

Fed hawkishness obviously amplifies this crowding out effect. The collapse in global liquidity creates intense international competition for financing, explaining the soaring real yields in Europe and the UK, whether locally appropriate or not:



Europe is in the same boat as the UK but with less underlying inflation pressure. The penny (or perhaps cent) will eventually drop that the only effective countercyclical policy mix to counter a looming depression is to monetize energy caps via yield curve control or targeted QE programs. No better choice exists than to accept that the cost of lowering inflation today and supporting demand is depressed real yields, currency devaluation vs USD and gold, and persistent inflationary pressures.

The BoE's alternative is to keep pounding on inflation with much higher real rates into 2023 (150bps for November 3rd and 350bps by the end of Q1 2023). But the cost is a deep recession and rising risks of financial instability. **You would be a fool to assume the UK's gilts drama is an isolated event.** After years of entrenched disinflation when everyone thought bonds were boring (which is why infinite leverage was offered in an asset class now more volatile than crypto), many institutions were forced to leverage their fixed-income exposure to offset collapsing yields. They will find themselves dangerously overleveraged today; **bond volatility and leverage have become systemic due to collapsing liquidity:**

The global yield shock will continue threatening global financial stability:
... This month the BoE's liquidity injections cut the immediate risk of a financial crisis, but what happens next?

Source: * The OFR Financial Stress Index is a daily market-based snapshot of stress in global financial markets.
MOVE Index (ICE BofA MOVE Index) Move & Financial sta Daily 01JAN1998-07OCT2022 Copyright© 2022 Bloomberg Finance L.P. 07-Oct-2022 11:42:03

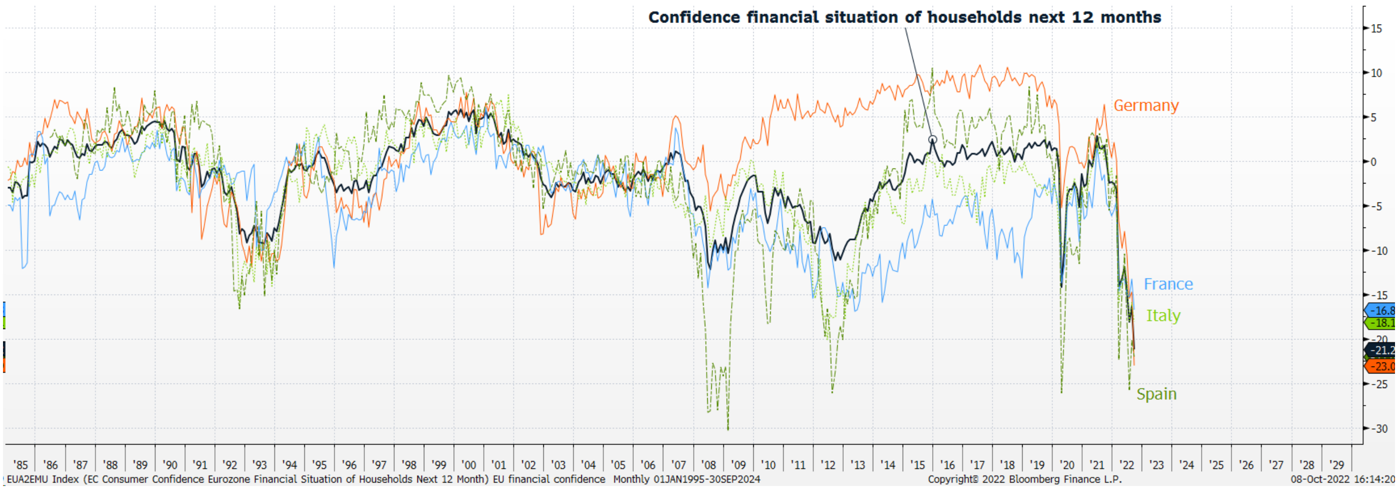
The next country to be tested by bond vigilantes is Italy:

The country's economy is one of the most exposed to a rationing of gas (with Germany) and to the energy crisis devastating Europe. There, electricity prices already exceed those elsewhere in the bloc and the country will enter a recession in Q4. Newly elected Italian PM Giorgia Meloni is yet to form a government, but we already know she is an anti-establishment fiscal populist likely to clash with the EU on fiscal righteousness. Amid a recession, she will rightly want to stimulate demand with tax cuts (her campaign pledges include cutting sales tax on energy and reducing the tax rate for the self-employed earning under €100,000 to a flat 15%) and various family subsidies designed to boost Italy's birth rate.

Needless to say, she has not disclosed the plan to fund these measures. Most likely, the demand stimulus will raise deficits and debts, and the EU will struggle to impose fiscal discipline on a newly elected government using fiscal policy to deal with the exogenous shock of a wartime energy crisis. So, the **discipline mechanism will come from markets through higher BTP yields and spreads.**

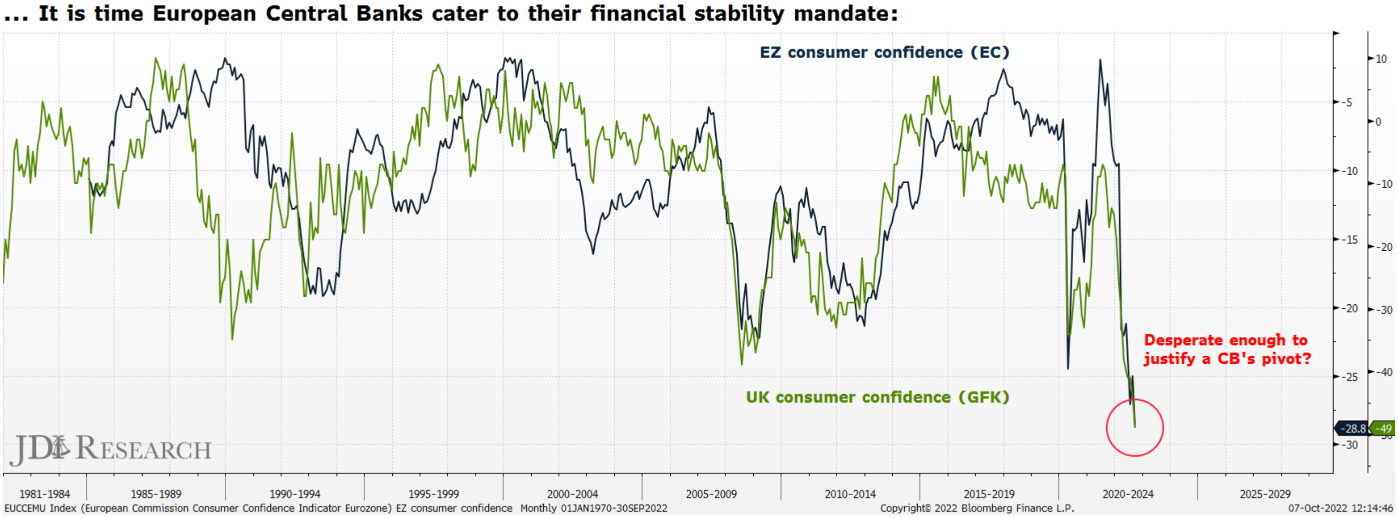
Around the 300bp BTP/Bund spread, markets will await the activation of the ECB's Transmission Protection Instrument (TPI) -- **I look forward to seeing how the ECB will justify buying Italian bonds while shrinking liquidity in other equally challenged jurisdictions like Germany.**

Financial confidence has cratered accross the European continent ...
... With Germany leading the pack:



Will the Italian purchases really be sterilized as initially intended? Or will the TPI be the perfect tool to engage in stealth QE?

Desperate times call for desperate measures ...
... It is time European Central Banks cater to their financial stability mandate:



Central banks can keep fighting inflation and risk a financial crisis and deflationary depression, or they can choose to accommodate the fiscal stimuli. Yes, they risk their credibility. But desperate times call for desperate measures, and we have leapt into a **binary macro world: a much slower path of disinflation or deflation. In both scenarios, central banks miss their inflation targets. But in the former, financial stability is preserved – a key driver of central bank policy.**

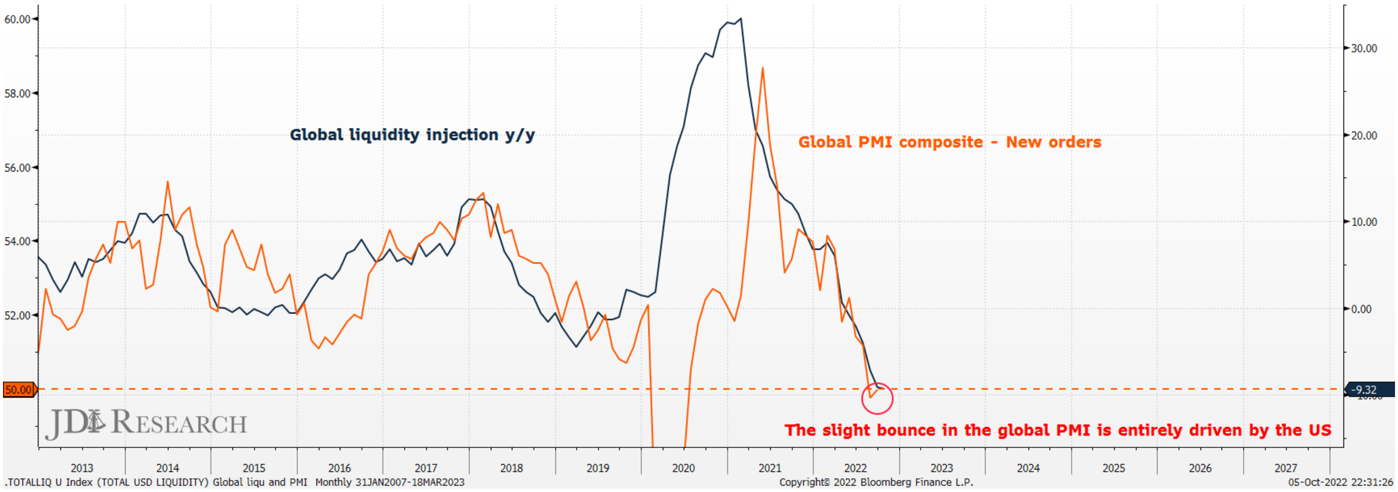
I think central banks will rightly settle for a more forward-looking policy framework, integrating the rising risk of deflation into their policy decisions. This means eventually accommodating the fiscal stimuli via yield caps and currency devaluation. **Marketwise, this means holding the Bund/BTP widener until 300bps, selling EUR vs gold, and raising cash levels to be ready to pounce on equities as a permanent fix to the crisis is reluctantly adopted: stealth monetisation.**

3. A two-faced dollar is smiling …

… Until the pandemic-induced excess liquidity in the US vanishes

The Fed's hawkishness compounds the rest of the world's woes because of the dollar's global reserve currency status:

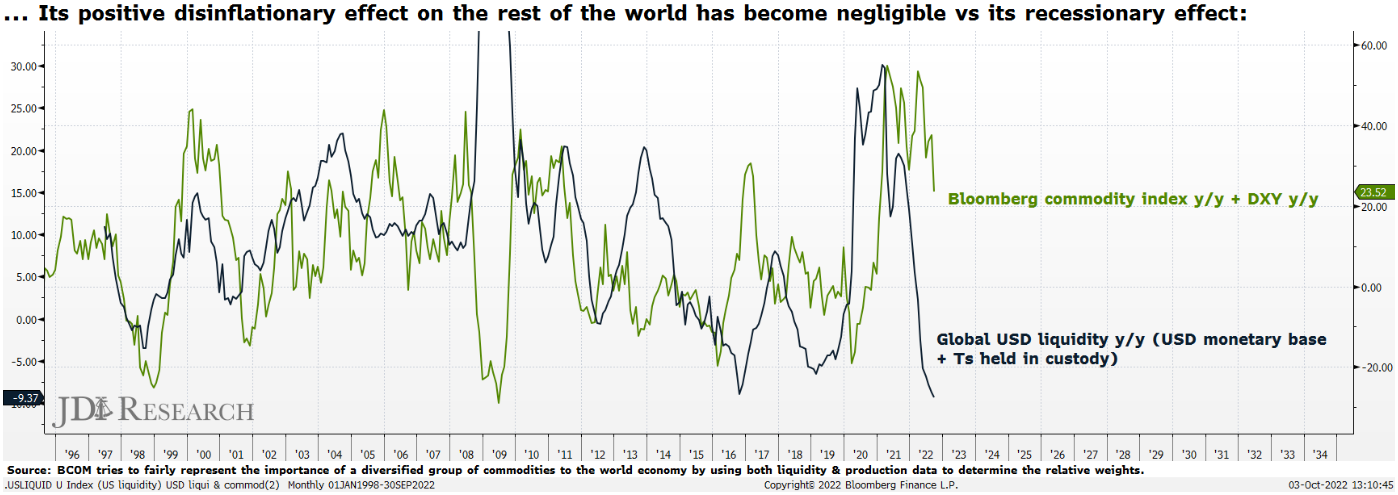
USD liquidity withdrawal brings global demand to its knees:



Making matters worse, just when supply-driven inflation is the biggest stumbling block, **the dollar strength from the global liquidity crunch prevents Europe from benefitting from its disinflationary effect.** Lael Brainard raised this in her [September 30th speech]:

"On balance, dollar appreciation tends to reduce import prices in the United States," she said. *"But in some other jurisdictions, the corresponding currency depreciation may contribute to inflationary pressures and require additional tightening to offset."*

Because the USD liquidity crunch strengthens the USD ...
... Its positive disinflationary effect on the rest of the world has become negligible vs its recessionary effect:



In short, Fed hawkishness has a virtuous aspect for the US consumer, who remains cushioned by pandemic liquidity but benefits from heavy global

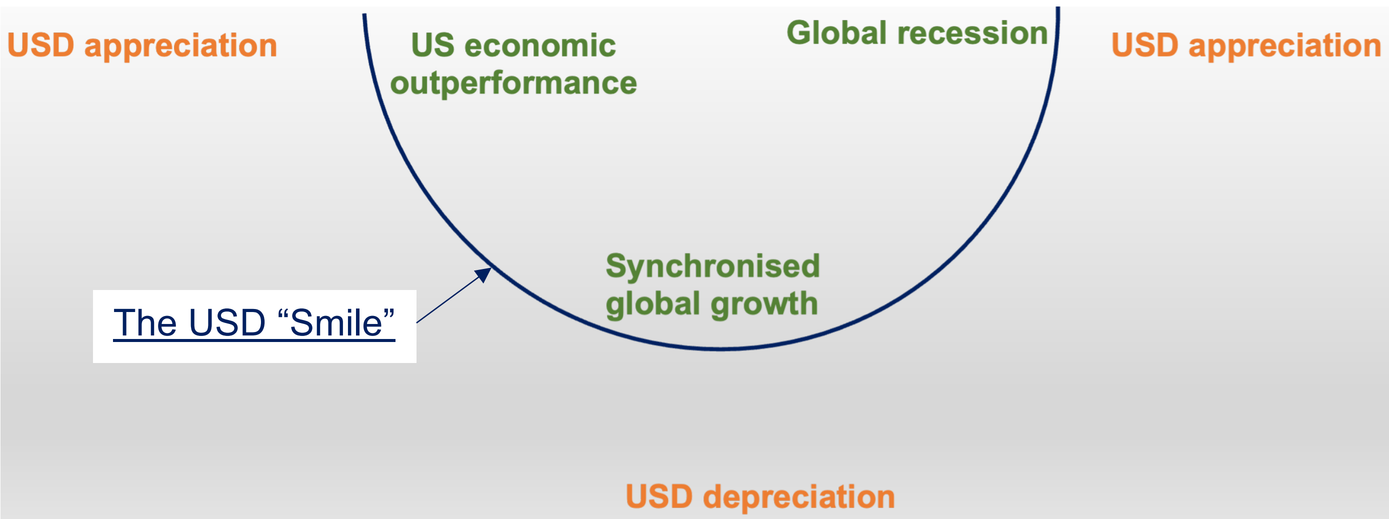
disinflationary trends. However, it is vicious for the RoW where self-perpetuating stagflationary forces will continue spreading until the Fed pivots.

Whatever path the rest of the world's central banks take (monetise or not), the choices are a global deflationary depression or financial crisis versus the more palatable option of a currency devaluation vs the USD and gold where the economic situation is the direst. Europe, the UK, Canada and Australia spring to mind given the energy crisis in Europe and UK, along with the excess vulnerability to higher mortgage rates in the fragile housing markets of the UK, Canada and Australia.

The USD smile:

As the global reserve currency, we can think of the USD as having two faces. One face is the domestic USD, which behaves like other currencies and is linked to the economy's relative potential. But the other is the international USD, which is the primary currency in global trade and drives the global liquidity pool.

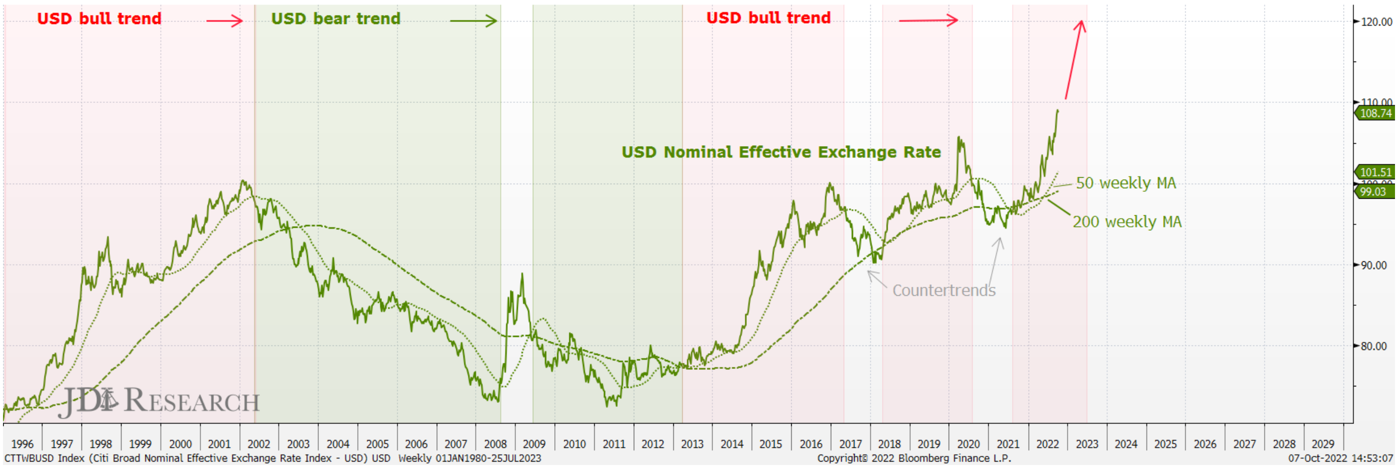
In both our likely scenarios, the USD strengthens. It is the "Dollar Smile Theory" coined by Stephen Jen, which argues the USD strengthens on both sides of the "Smile": US economic outperformance (domestic USD) or a global recession (international USD):



The BoE's recent liquidity injections temporarily remove the tail risk of an imminent financial crisis, hence the recent USD relief. But as mentioned, it is a band-aid on a lethal wound; the surgery is yet to come.

Ultimately, the US pandemic-induced excess liquidity will vanish, allowing the US exceptionalism to fade and the USD bull trend to end… but not before a last hurrah:

The decade-long USD bull trend will end eventually ...
... But not before a major last hurrah:



In her [September 30th speech,] Brainard discussed the risk of global financial instability from a Fed policy that responds to domestic considerations while ignoring its international mandate:

"We are attentive to financial vulnerabilities that could be exacerbated by the advent of additional adverse shocks. For instance, in countries where sovereign or corporate debt levels are high, higher interest rates could increase debt-servicing burdens and concerns about debt sustainability, which could be exacerbated by currency depreciation. An increase in risk premiums could kick off deleveraging dynamics as financial intermediaries de-risk. And shallow liquidity in some markets could become an amplification channel in the event of further adverse shocks."

She also acknowledges that *"risks may become two sided at some point"* but concludes with a *"commitment to avoiding pulling back prematurely."*

The issue today is that the Fed, like the US government, is pursuing its own domestic interest, which runs counter to European ones. And that interest is financial stability via lower inflation expectations and a stronger USD.

In the first section, I concluded global disinflationary trends were currently a windfall for the US consumer. Given that, **I now conclude the first signs of global financial instability are unlikely to sway the Fed.** This means there is currently no hurdle to a vicious USD revaluation vs other fiat currencies. Also consider the geopolitical war: commodity producers' ultimate goal is to discredit the USD as the global reserve currency, so the Fed is also at war.

This week, OPEC+ decided to substantially cut output quotas to defend oil prices. The move only reinforces the macroeconomic ramifications of the global commodity and economic war, which is now in the open. On one hand, the OPEC+ cartel's decision will further test Europe as it enters an economic downturn; on the other, the decision deals another blow to budding US disinflation.

This reminds us of the limits which economic powers face in a world where you must depend on others for key natural resources.

Executive summary:

- The US economy is yet to show game-changing signs of endogenous weakness. It may yet endure even higher yields.
- However, **the Fed's hawkishness is hurting the rest of the world, where it drives relentless stagflationary forces.** Bar an energy miracle, the choices in Europe and the UK are a deflationary depression or stealth devaluation. Will it take

teetering on the verge of depression before electing monetisation and slower disinflation?

- As domestic disinflationary forces become evident in coming months, the Fed will pivot -- either because lower real yields abroad have unleashed ferocious USD strength or because overly tight global liquidity threatens global financial stability. **As US yields never turn overly restrictive for the US economy, this should ensure a US soft landing.**

- **Raise USD cash.** Amid unprecedented macro uncertainty, opportunities will arise.

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