The Daily Feather

Global Growth Memo to Markets: Fade the Inflation Scare

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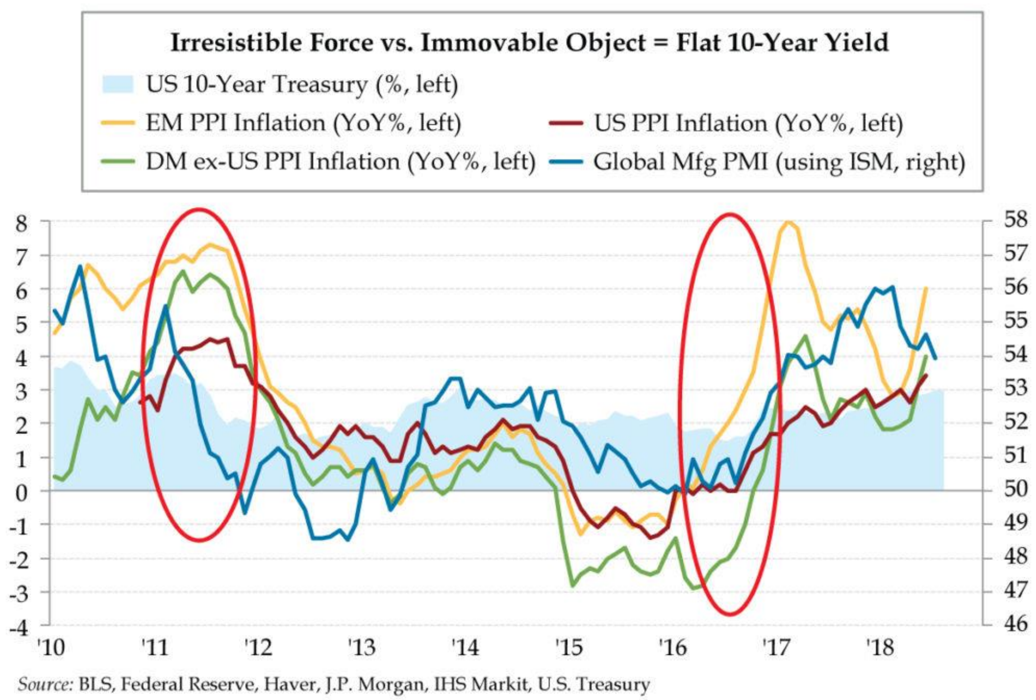

VIPs

- U.S. PPI Final Demand goes beyond commodities capturing service firms' pricing and providing a fuller economic outlook
- PPI Final Demand inflation rate hit a seven-year high in June and is

expected to hold at 3.4% in July

- Producer prices accelerated through June but arrested in July; agnostic 10-year yield ignores data, bound between 2.8-3.0%
- Evidence points to global growth slowing — downside risk to build through yearend
- Treasury markets are anticipating higher yields; global growth suggests otherwise
- Markets trade off frequent data points but fundamentals always win in the end. Look out below.

What happens when an irresistible force meets an immovable object? Star Wars fans conjure the sensation of the Force struggling to defeat the Dark Side, Rey meets Kylo Ren in *The Last Jedi*. Marvel fans' minds jump to Juggernaut's battling The Blob. Classic wrestling fans wistfully recall Hulk Hogan's smack down with Andre the Giant. And 10-Year U.S. Treasury fans, who need to get out more, summon the ultimate confrontation: global growth vs. global inflation.

The benchmark 10-Year U.S. Treasury yield wins the title of the global risk-free rate; it reflects both global growth and global inflation. Global growth, whether measured by GDP or via proxies such as Purchasing Managers' Indices (PMIs), are straightforward influences on rates — faster growth is to higher rates as slower growth is to lower rates.

Global inflation – that is, the nemesis common to all citizens of Planet Earth – can be gauged using commodities markets. These commonalties filter through to producer price indices (PPI) directly in raw and intermediate materials prices and to a lesser extent in finished goods.

Today’s U.S. PPI was redefined in recent years to reflect more than just commodities, with the aim of being a broader metric that also captured pricing trends being felt by services firms. The new and improved name by which the headline is now identified: “PPI Final Demand.” The crystal-ball gazing consensus expects June’s seven-year high PPI inflation rate of 3.4% to hold in July.

It stands to reason that the preponderance of PPIs is of the country variety. Ergo, global measures are hard to come by. That changed in 2014 with the Dallas Fed’s Globalization and Monetary Policy Institute’s introduction of a global PPI. This dataset, as described in 2014 by co-authors Grossman, Mack and Martinez-Garcia, is unique in that it excludes the U.S. and it includes two subcomponents, one for Developed Markets (DM ex-U.S.) and another for Emerging Markets (EM).

Through June, producer prices were accelerating in tandem across the U.S., Developed and Emerging Markets. July, however, witnessed a pivot to deceleration — in growth. What has the 10-Year yield done in June and July? Stuck in a rut between 2.80% and 3.00%.

Irresistible force vs. immovable object, right? Not so fast. There is a flaw here. Call it the irresistible force paradox. If an irresistible force exists, then by definition an immovable object cannot coexist alongside it. Unless…

Refer back to 2011 on the above chart. Global PMI slowed, and PPI inflation rose across the board. Which way did the 10-Year go? Down. Now hone in on 2016. Global growth accelerated concomitant with an **acceleration** in global inflation.

The yield on the 10-Year? Up.

Growth wins out as the irresistible force.

Where are we today? Global growth momentum has dissipated in the first half of this year. Markets point to downside risk as the calendar relentlessly pushes us towards the fourth quarter. That suggests the days are numbered for the rally in global PPI inflation and for the relatively stable path of the 10-Year Treasury. Repeat after us: “Growth leads inflation.”

And yet, markets are pricing in anything but lower yields in the second half of this year. Eighty-three percent of those surveyed by Bloomberg in July forecast a **higher** 10-year yield by yearend. Should the risks we’ve just described manifest and yields head lower, the Treasury market is in for the mother of all pain trades.

In the meantime, technicals that should push up rates are front and center for rates strategists. Three come to mind:

1. The Federal Reserve’s Quantitative Tightening (QT) will step up again when the fourth quarter arrives.

2. The Treasury has to increase the supply of Treasuries to fund trillion-dollar deficits. Yesterday’s record $26 billion 10-year auction was the tip of the iceberg.

3. Pension funds piled into longer-dated Treasuries to qualify for more favorable tax deductions at the 35% corporate tax rate before a mid-September reset to the new 21% rate.

So there's that…in triplicate. But recall Econ 101: Fundamental factors are slow-moving. Markets refuse to trade on emerging themes fundamentals are advertising. They trade like young, impulsive boys based on whether the data come in above, below or in line with forecast. Diagnosis: hormonal tunnel vision.

<u>But growth and inflation are fundamental factors that govern economic outlooks; they rightly ground veteran strategists.</u> And while we have to exercise patience to navigate a whole month of data before the fundamental picture of PMIs and PPIs reveals itself, we caution against fading any signs of slower growth or lower inflation, even if it's of the PPI variety markets love to ignore. The irresistible force of growth, and especially a lack thereof, will win the day.