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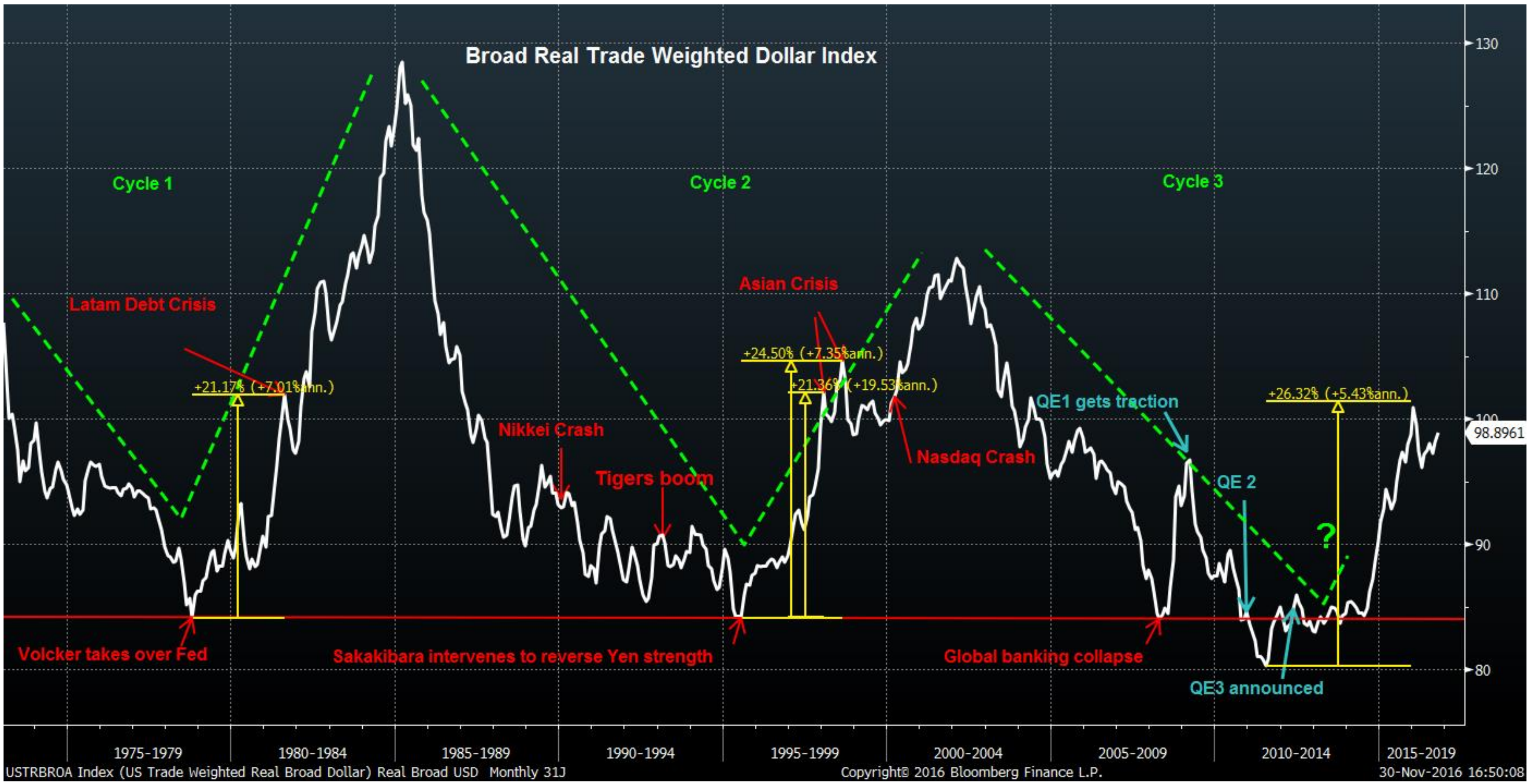
Macro Voices

December 2016

Back in May we showed you this chart and said the $ sets the cycle in everything from growth to inflation

The explosive $ rally from 2014-2016 was toxic for EM and commodities. However, starting in January we got "a pause that refreshes" and while the $ has started to rally again those positive reflationary effects are still feeding through the economy



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Fixed Income

Having been utterly distorted by misdirected central bank policies so far the sell off in bond markets is simply a reaction to a cyclical growth/inflation rebound, which itself was generated by the dollar's pause. Hence pricing is fully justified by <u>existing</u> fundamentals and has little to do with prospective Trump policies…yet

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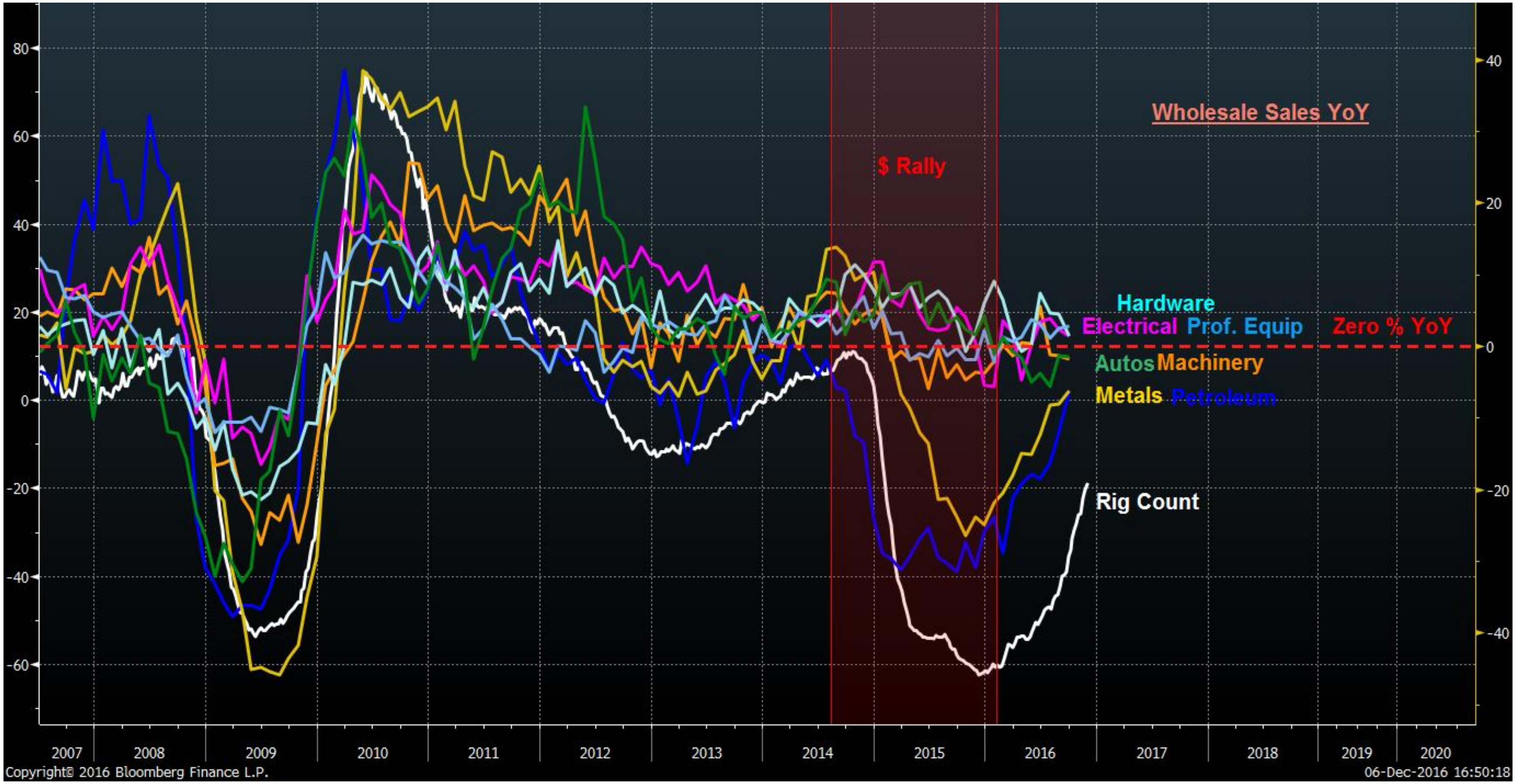
The $'s rally savaged the energy industry and burst the US shale bubble but that is now finally dropping out of the data

Because we typically measure the "speed" and not the level of growth exogenous shocks eventually drop out



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However, the $'s impact wasn't just felt in the US
Global trade was also crushed but it now rebounding

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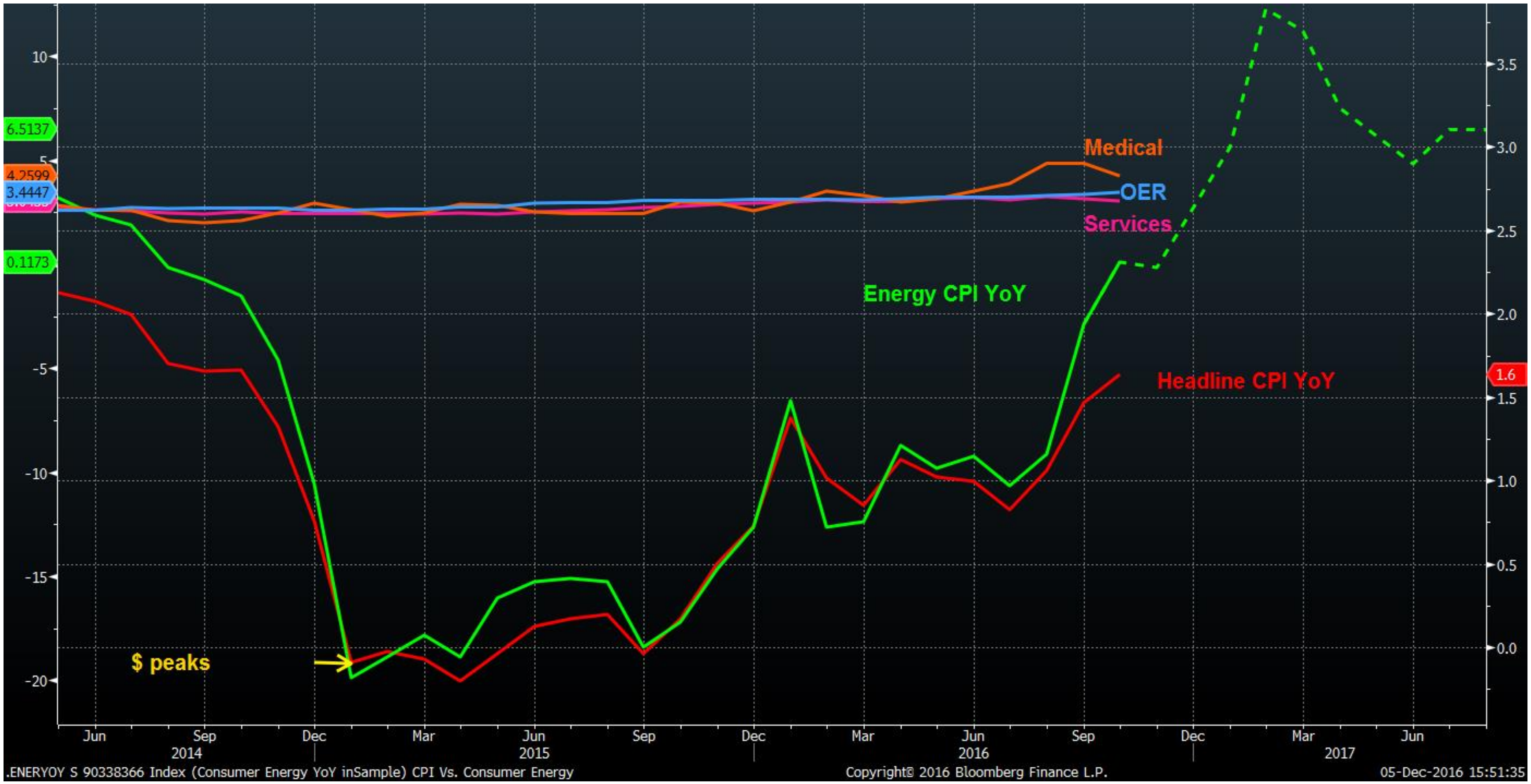
Now we have to deal with inflation

In addition to growth we now have inflation
In the US pressures will continue to build well into Q1

Note despite the belief of central banks we didn't have deflation just a bout of energy disinflation



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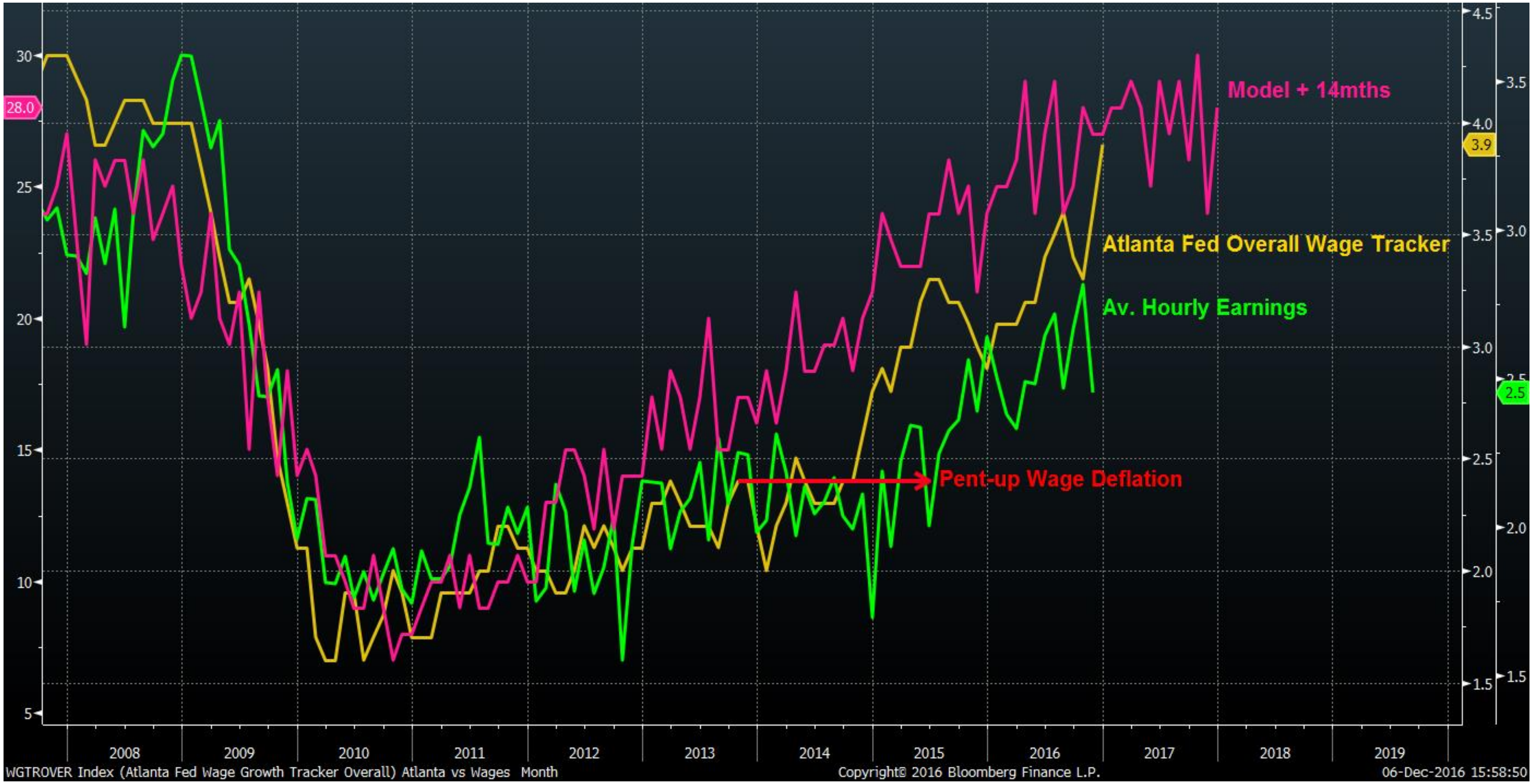
But it's not just headline inflation
Even before Trump's plans we are seeing wage inflation

After an extended period of pent up wage deflation we are finally seeing wage growth
Average hourly earnings will exceed 3% next year and feed straight into core inflation



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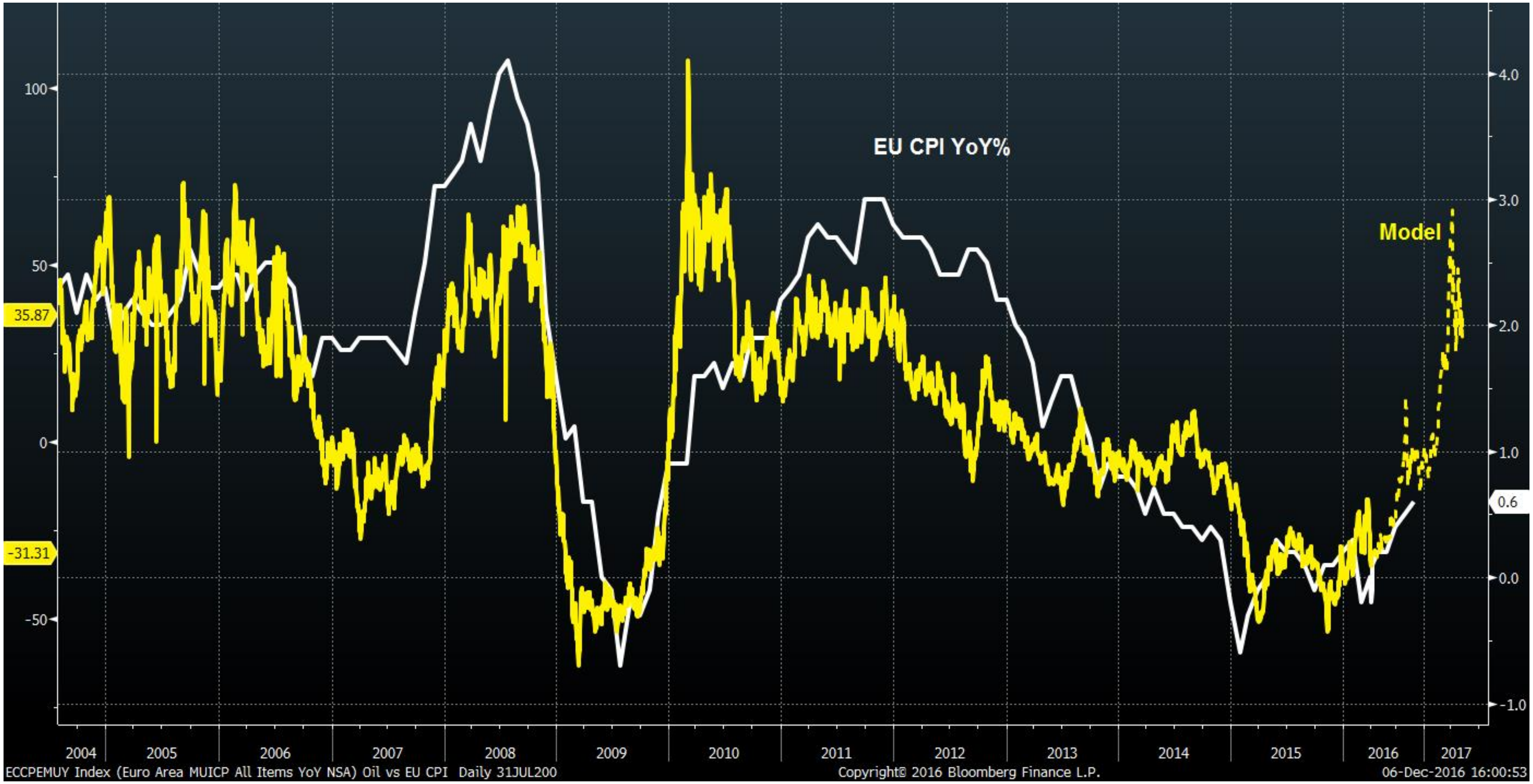
Significantly we are also seeing inflationary pressures in Europe which is meant to be mired in deflation

In the **European PMI** they said

"Eurozone manufacturers are enjoying the best improvement in business conditions for almost three years, as the benefits of a weaker currency and strengthening demand helped firms brush off political worries…A combination of rising demand for raw materials and the weaker euro meanwhile meant input prices surged higher, feeding through to increased factory gate prices. Manufacturing output price inflation is currently running at its highest for over five years, which will inevitably translate into higher consumer prices in coming months.

We couldn't agree more!

In Q1 European headline could easily exceed 2%



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In China we are seeing a burst of inflation especially in Producer Prices

At the start of the year they were falling at -5% YoY but could hit +5% in Q1

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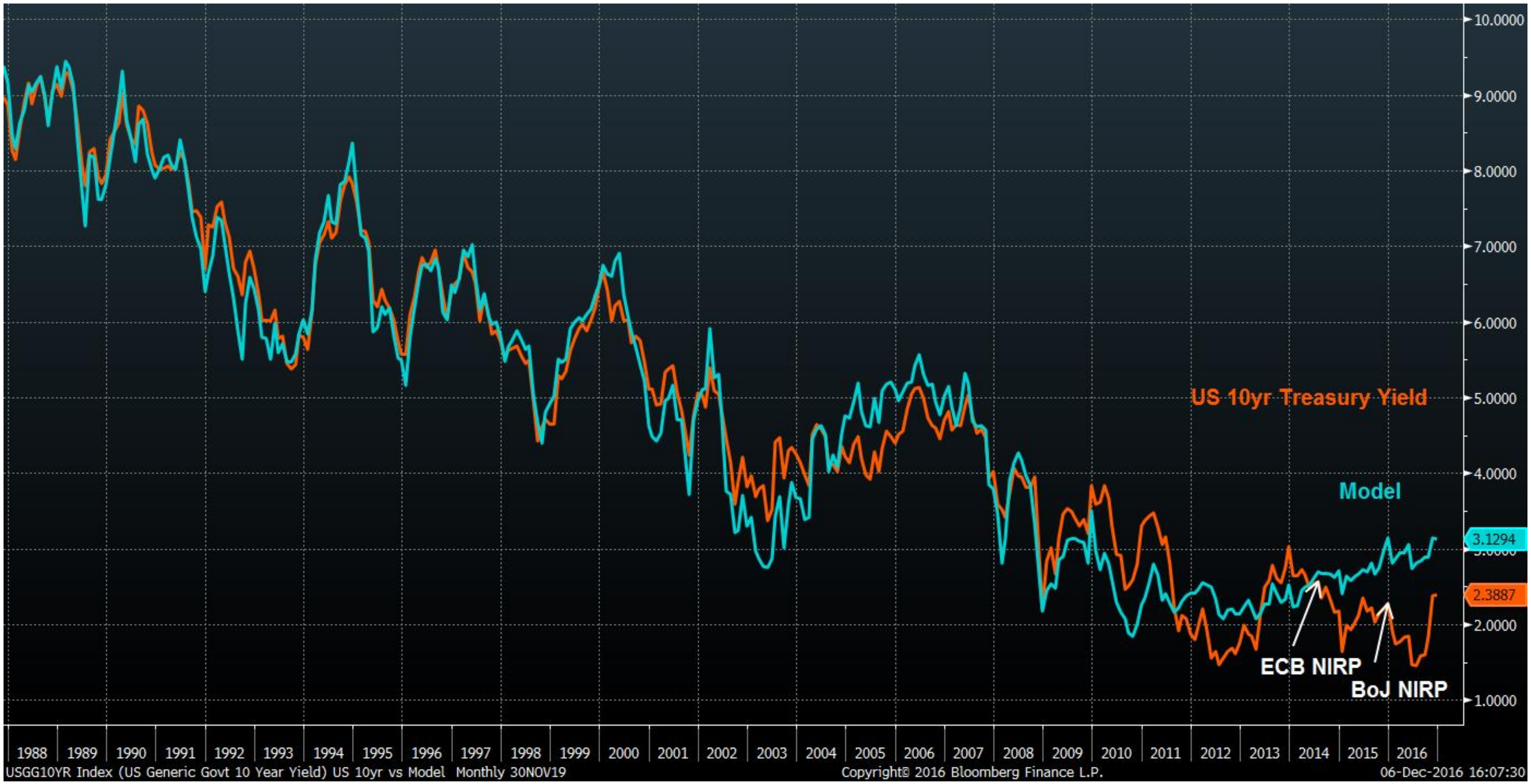
Once again you are seeing it in the PMIs

Caixin China Manufacturing PMI: Index readings *"tracking input and output prices rose at a faster pace to hit their highest levels in five years, pointing to further intensification of inflationary pressure."*

What if China moves from exporting deflation to inflation?

The point is that even before Trump policies are enacted our work suggested bond yields should be higher

Our macro model suggests 10yr Treasury yields should be 3% and the only reason they weren't was because of misdirected central bank policies. Policies that have failed



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The Dollar

As with fixed income the key thing to note is that so far the $’s rally is quite normal and supported by fundamentals

Interest rate differentials fully support current dollar pricing

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That's where a corporate tax repatriation deal gets interesting

The original HIA resulted in about $300bln being repatriated in 2005. The only year the $ rallied in almost a decade

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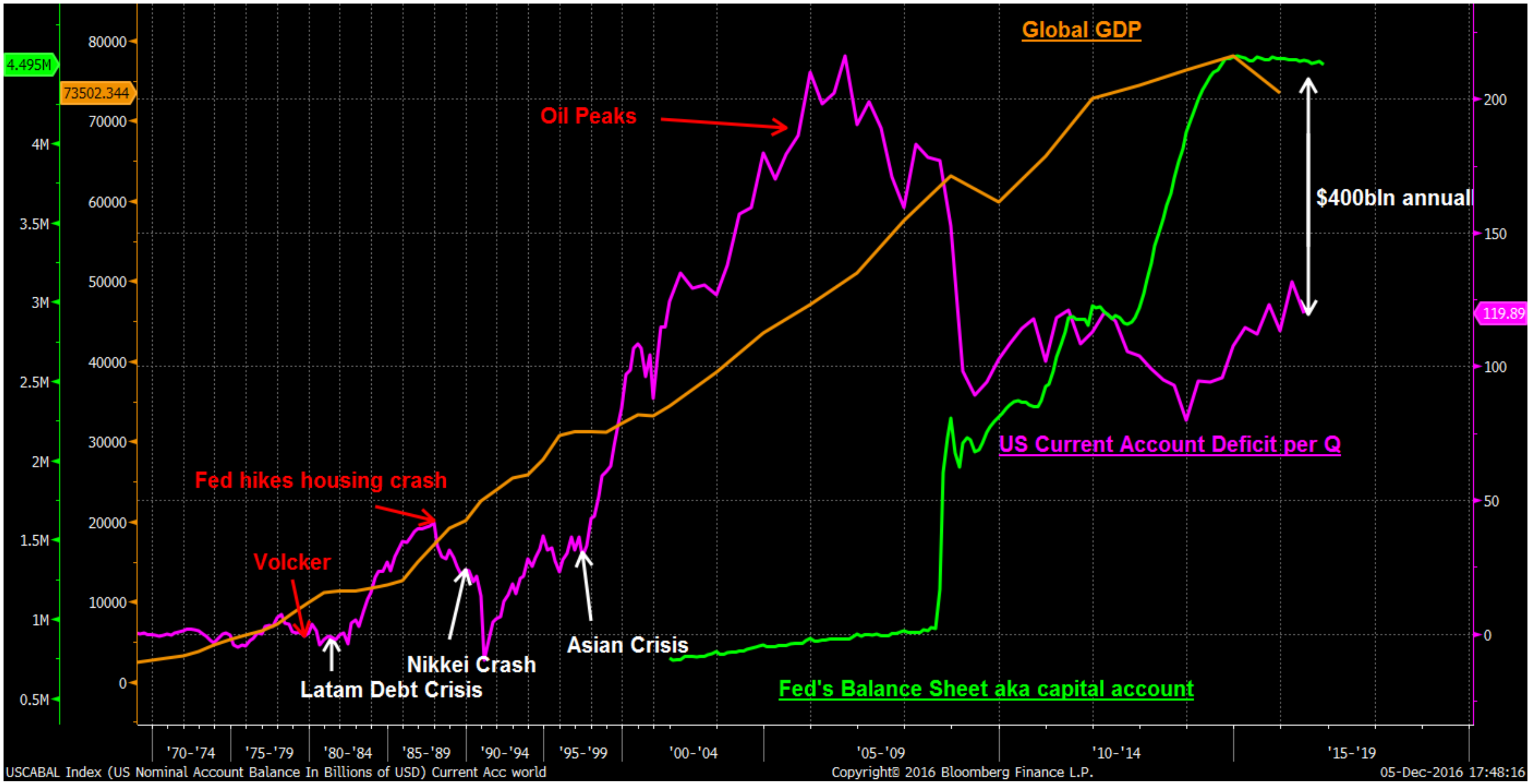
But it's not the price of the dollar that worries us as we've explained before it's the supply of dollars

In the past, Fed tightening curtailed consumer spending tightening the $ supply via the current account but this time the issue is more structural thanks to shale which has replaced energy imports. Given this inherent instability at the heart of the reserve currency if you repatriate corporate dollars the impact will be fatal



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