Juliette Declercq: “Dovish Pivot” is not a game-changer yet

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Erik: Joining me next is JDI Research founder Juliette Declercq. Juliette has prepared another of her fantastic chart books for us so be sure, listeners, to download it. You can find the download link in your Research Roundup email. If you’re not registered yet, just go to macrovoices.com, look for Juliette’s picture on our home page, and the red button that says “Looking for the Downloads” next to her picture.

Juliette, you have had a grim outlook on global activity since January of this year. And you’ve successfully translated that into substantial profits for your clients this summer. My question now, though is: Is the Trump/Xi agreement from the G20 a game change, as so many people seem to think it is?

Juliette: Erik, that question is pretty much a whole JDI Research report on its own. But I’ll try and reply to it in a concise manner today and leave the reviewing of all leading indicators for the Vancouver conference in January.

The quick answer is that the trade war certainly aggravated the global slowdown but it did not cause it. What really caused the global slowdown is a comprehensive confluence of factors which I’d like to review now.

Firstly, a much tighter dollar liquidity. Now, it will not be a surprise for your listeners to hear that the global liquidity tide is intimately connected with US dollar liquidity. But I’d like to quickly go through this mechanism again, because it’s one of the keys to the 2019 outlook.

Since World War II, the US dollar has been the primary global reserve currency. And, in practice, it means that the dollar is at the crossroads of most real transactions, even when a transaction is priced in another currency and involves two countries other than the US. That’s simply because the countries’ respective banks main reserves are held in US dollars rather than whatever, yen or sterling.

The result is that when Japanese goods are exported to the UK and the payment is made in yen, the UK firm will effectively intermediate via eurodollar contracts, which is basically US dollars available outside the US.

The upshot, and this is really key, is that the Fed, whether it openly acknowledges it or not, is the world’s *de facto* central bank. So, when engaged in quantitative easing, the Fed floods domestic banks with reserves and increases the domestic monetary base.

This actually causes US demand to start growing faster than in the rest of the world, which causes the US current account to swell and basically floods the rest of the world with US dollars too. The result is that the Fed doesn't only increase the monetary base domestically, but it also increases the monetary base abroad and generally the global monetary base increases.

This year, as you know, the Fed's engaged in quantitative tightening. That's the first thing you will see on Chart 1. It means that global dollar liquidity stopped accelerating earlier this year and actually started to shrink this summer. So almost mathematically global growth followed through.

The hurdle for global dollar liquidity to reaccelerate today or next year is enormous. And it would probably take a global recession for G4 central banks to walk back a collective intent to get away from balance sheet normalization.

So, really, there should be very little relief coming on this side for 2019.

The second culprit for the global slowdown is China. The October 2017 National Communist Party Congress had the honorable ambition of shifting the country towards a longer-term, more sustainable growth model less reliant on infrastructure investments and, basically, easy money. The result: considerably more restrictive monetary and fiscal policy frameworks.

You will see on Chart 2 that it triggered a collapse in the credit impulse in 2018.

Now, many believe this is old news. Faced with a raging trade war with the US, Chinese authorities have tried walking back the tightening in financial conditions, by engaging in a series of monetary and fiscal stimuli to stop the downward trend in activity and shore up confidence. But this has been met with very little success so far.

As you will observe on Chart 3, the six-month fiscal expenditure and total social financing impulse has continued to collapse. And there has literally been no organic growth in private credit.

Investors today are still hoping for a return – even if temporary – to China's old economic model, which is basically a model necessitating large imports of commodities, material, and industrial goods, and whose comeback would effectively be a boon for countries that are most leveraged to global trade: emerging markets and, to a lesser extent, the EU.

This could work in the short term because fiscal expenditure tends to be frontloaded to the start of the year in China. But in the longer run, though, we have a small problem, which is that wave after wave of stimuli have been used in China to boost fixed-asset investment.

And the inevitable consequence is overcapacity issues and dramatically lowered expected returns on investment. And that's especially true with the state-owned corporate sector.

The next consequence of this is that looser credit standards are not really sufficient to support the economy. To spur economic growth at this point, it is the price of credit which needs to be addressed via lower yields rather than its liquidity.

This is something you will see on Chart 4. In 2015, the drop in nominal GDP growth was accompanied by a commensurate 150 basis points cut in the official lending rate – and that was on top of liquidity injections – which allowed corporate yields to drop in line with the much softer macroeconomic outlook.

It also allowed a sharp turnaround in credit flows. But on the same chart you will see that in 2018 the problem is that only high-quality AAA corporate yields have dropped meaningfully, by about 100 basis points. But for the rest of the credit sector, we still have the exorbitant price of credit. And that means that companies are reluctant to deploy new capital.

Erik: Juliette, I cannot wait to get both you and Jeff Snider onstage at the same time to talk about eurodollars. But we'll have to save that for Vancouver.

Meanwhile, though, what you're saying here is that the problem in China is that they need lower yields. So why don't they cut rates?

Juliette: The problem that the PBOC faces today is really an impossible trinity. This year it's been instructed to discourage capital outflows and promote CNY's credibility as a store of value.

The dilemma is that both mandates are mutually inconsistent. It's virtually impossible with the Fed hiking to lower official rates in China and keep the CNY stable at the same time. And that's something you can observe for yourself on Chart 5. That's basically because China's capital flows are highly sensitive to the differential between the PBOC and the Fed's official rates.

In addition – and this is something that the US Treasury Secretary Mnuchin reiterated today – the elusive China-US trade deal would no question contain a clause preventing China from FX depreciation.

The fact that the can was kicked 90 days down the road means that Chinese authorities are prevented from loosening monetary policy further, or they would basically face 25% tariffs on all exports.

I think this is perhaps the smartest outcome of the G20 meeting between Xi and Trump: literally dragging the dispute out in time guarantees that China-induced deflationary pressures will stay at home in China.

Conversely, a breakdown in negotiations would have most certainly caused Chinese authorities to pull the trigger on lower rates and cause a sharp depreciation of the renminbi. So it is actually quite sensible for the US to keep negotiations in limbo. But it doesn't mean that an armistice will follow the truce.

For now, I think the bottom line is that, in China, the credit channel is clogged due to the yuan's stability constraints and that the truce is unlikely to benefit the Chinese economy much, especially as uncertainty remains.

Of course, you'll now ask me about the fiscal side as well. And I'd like to add something on that. I think Chinese authorities are still dead set on rebalancing the economy away from investment towards consumption. And that means that even a massive fiscal impulse comparable to what we had in 2009 or 2014–15 would be aimed at boosting consumption to benefit the domestic economy. And that would mean – it's a plus for China but it doesn't contribute to reflating the rest of the world.

In other words, trade war or no trade war, I think global growth, the global economy, is stuck in low gear.

Erik: Okay, so big picture-wise it sounds like your view is still that the global outlook continues to be challenging. Is that correct? And is there anything that would make you change your mind there?

Juliette: Of course, many things can make me change my mind. I'm in no way dogmatic and I'm constantly looking for reasons I might be wrong or become wrong.

For example, the day before Powell's speech a couple of JDI Research sentiment indicators hit overly depressed levels, and I recommended taking profit in all risk-off trades ahead of key risk events, and warning that the 2019 consensus outlook had become a bit too grim.

There is another level on global growth than the quantity of dollars, and this level is basically the price of dollars. In 2018, adding insult to injury, the US dollar strengthened. And that was obviously due to macro and monetary policy divergence.

The issue there is that it amplifies the dollar liquidity squeeze. The strengthening dollar automatically deflates the level of existing global liquidity and causes FX reserves to shrink globally. And that basically undermines global economic prosperity.

However, the reverse can also be true: The existing global monetary base would revalue on a weaker dollar. As a result, the dollar really still holds the key to the global outlook in 2019. This is something that you can observe for yourself on Chart 6.

Erik: Juliette, what an opportunity to ask you about the dollar, something I've been dying to do. As you mentioned the potential of the US dollar as the world's savior, I want to ask you about your view on the Fed. A lot of people are now saying that Powell's speech in New York was a dovish pivot. And we've even had some people on this program predict that the

December rate hike will be the last rate hike and it's all over.

Is there really a dovish pivot here? And what would undermine the US dollar enough to brighten up your 2019 outlook?

Juliette: I think on that particular speech, markets were very long dollar. Consensus, as I just mentioned, turned really overly bearish the day before. Even moving away from like 2020 consensus for a recession to 2019.

Really, markets were preconditioned to respond to any dovish tilts. So there is definitely an element of confirmation bias in last week's turnaround in risk and the dollar following Powell's speech at the New York Club.

What I think is that the specific mention of rates being "just below the neutral range" and the supposed U-turn since October's "we are a long way from neutral" were over-interpreted.

The broad range of FOMC estimates is at the moment 2.5–3.5%. And the target range for the Fed funds is now like 2.0–2.25%. So I think Powell was really just stating a fact, that the Fed is just one hike away from the bottom of that neutral range.

Does this mean that there was no change in the Fed's reaction function? Absolutely not. But what it means is that what did not make the main headlines was where the dovish tilt actually was.

I think I was more interested to hear Powell talk about "the economic effects of our gradual rates increases being uncertain" and the fact that "they may take a year or more to be fully realized."

My view on that is that such an emphasis on the long lag between monetary tightening and financial tightening will allow the Fed a clear path towards more data dependency. And, indeed, I think it was really Vice Chairman Clarida's comments last week which were much more revealing. He noted that R*, the neutral rates estimates are highly uncertain and that participants will be revising their estimates based on incoming data at each FOMC meeting.

So I think, really, the bottom line is that the Fed's reaction function has changed and it's moved from being on a passive autopilot to be more readily responsive.

In my opinion, this is a case of getting to the same level of interest rates with a more dovish tone, which I argued all year would be a more sensible strategy. And I think this could be sufficient to cap real yields and halt the broad dollar advances, but it will not be enough to support a much stronger global outlook via a deeply and broadly weaker dollar.

And I think this is because the US economy re-convergence with the rest of the world will not be so abrupt as to warrant an immediate Fed pause. So, on that, I really disagree that the

December hike is going to be the last one. In fact, I continue to expect hikes to be delivered at the pace of one per quarter at least until 2.75. So that's three more hikes versus about two priced. And I would eventually look to fade the dollar weakness, especially versus China.

Erik: Well, we're definitely in agreement that the market over interpreted Powell's comments. But then you made some other comments that maybe were more open to the possibility of that dovish pivot. So do I understand correctly, the dovish pivot is not a game changer yet?

Juliette: The one thing to bear in mind when analyzing monetary policy (and its effect on financial assets) is that it only hits aggregate demand with an average lag of up to six quarters. In fact, our cycle analysis suggests that monetary accommodation leads aggregate demand by two years and that it starts being priced after about 18 months. You can see that on Chart 7.

Such considerations allowed us to start taking this strict risk-averse approach this summer. You will see on Chart 7 that the past Fed tightening is only just flowing out of the pipeline.

I think the issue there is that traders are trained to observe and anticipate the prompt and sometimes instant pricing in financial assets of events or data releases. And I think I would be speaking for all of us by saying that patience is one of our greatest challenges. But it's obviously a lot worse when it's up to 18 months, when you have to be patient for up to 18 months.

Often the lack of timely price confirmation leads investors to give up the macro framework altogether. And, actually, it is definitely part of my job to keep the relevant macro trends on the radar and to ring the bell, basically, when they are in play.

In this particular case, the crux of the matter is that it should be no surprise at all to see financial assets be de-rated as monetary conditions tighten. And this is actually part of a healthy, natural selection process where the zombies are finally left to die and capital can be redistributed more predictably.

So, thinking about the Fed, in deciding whether it needs to react to a financial asset riot, it needs to determine whether the ongoing repricing is directly linked to sharply deteriorating growth prospects or whether it's simply down to the reactivation of financial assets after years of super-loose monetary policy.

On this, I would like you to take a look at Chart 8. You can see on the equity side that tighter monetary policy naturally comes in tandem with a lower price-to-earnings ratio. However, the metric that really counts for me and that we should look at – because it accounts for normalizing real interest rates – is the equity risk premium. And that really only appears to discount a softening of the growth profile.

Clearly more worrying is the sharp widening in credit spreads and, again, you can see that on Chart 8. But how much of this deterioration in the quality of credit is just down to easy money-induced debtors' behaviors coming back to haunt them? It could simply be payback time after years of debt-financed equity buybacks.

If we had easier financial conditions, it would really only incentivize the return to non-productive investments. And that would be to the detriment of long-term economic prospects.

Historically, you will see (still on that chart) that the Fed has only reacted to widening credit spreads when it was combined with growth falling below potential. And yesterday's ISM showed us that we're still very far from there. That's a capitulation that we observed in 2016 when ISM manufacturing fell below 50 – and that would be, basically, recession territory. And high yields credit spread exploded. But we are nowhere close to that sort of red alert.

Erik: From what you're saying, it sounds like you think the Fed would be ready to react to a sharp economic slowdown if one were to occur. But the question that begets is: Is that something that's in the cards for 2019, based on your outlook?

Juliette: I think there is no question that the US economy is slowing. But this should not really be a surprise to anyone. After all, it is the Fed's goal to cool aggregate demand down and target growth sustainability.

In fact, to me the real surprise should be that the US economy is still running way above potential. And the manufacturing sector is so strong, especially versus the rest of the world, at the end of the second longest expansion on record after eight hikes and with strong headwinds stemming from the weaker global outlook and also a much stronger dollar.

Earlier this year, I highlighted that monetary conditions were no longer loose for the consumer. You can see that on Chart 9. Buying conditions are definitely tighter for cars and houses. And this is really something that was confirmed by the sharp drop in the NAHB homebuilders optimism index that you can see on Chart 10.

Erik: I want to pick up on that theme, because US housing is a subject that awakens a passionate feelings for a lot of our listeners. Can you give us any further insights on the US housing market?

Juliette: Definitely. I've had a deep look into the US housing market, as it's obviously an important piece of the US macroeconomic puzzle. And my conclusion is that it will undoubtedly contribute to the slowing of the US economy. But it is in no way systemic. In fact, I would probably argue that medium-term fundamentals remain quite solid. And I will show you a few charts supporting this view.

Firstly, you can see on Charts 11 and 12 that housing supply has been in line with potential demand since the subprime crisis and inventories are actually very low.

The second thing is, on Chart 13, you will see that affordability has worsened, obviously, but it remains historically quite good. And my non-consensus view is that tighter monetary conditions may actually be necessary to restore price affordability.

You know, I think it's quite easy to forget that super-loose monetary conditions have largely contributed to housing bubbles, especially where supply was quite limited. Prime examples are London or Vancouver. Runaway house price pressures have caused affordability to worsen for new entrants. For example, on Chart 14 you will see that the US median household has been slowly getting priced out of home ownership again through this cycle. And, in my view, this really explains why the home ownership rate is only just recovering.

The scar of the subprime crisis is still healing. And I can understand why it's tempting to infer from past experience that we are on the brink of recession. But let's not forget that regulations have tightened credit conditions.

House equity withdrawal has been strictly limited over the past decade. And that results in a much lower correlation between this business cycle and the housing cycle. In addition, normalizing real rates automatically softens prices, which is more of a blessing for the "have nots" than a curse for the "haves" because it restores price affordability and helps lessen intergenerational inequalities. I think this will eventually boost home ownership and support growth.

So my conclusion really is that the ongoing slowdown in residential investment is not a harbinger of recession. More likely, housing demand is taking a breather due to higher prospective mortgage payments. But that's in expectation to leave price affordability to rebuild. And I think it would be a mistake for the Fed to make a U-turn just because of a softer housing market.

Erik: Okay, so I'm going to put you on the spot here. Where in your best estimation would you see a pause actually occurring in the Fed's hiking cycle?

Juliette: My current estimate is that we see a minimum of six months before the Fed's domestic mandate converges with its global mandate on the weaker US economy. I think that should take US interest rates to 2.75%, which, again, is like three more hikes.

By that point, I think that low inflation readings and disturbing activity trends should compel the Fed to pause. And it will even appear then that the long-term neutral rate is in fact lower and that monetary policy has turned overly restrictive.

Erik: Any other strong market views?

Juliette: I know you always want to know about the dollar. And my conclusion there is that it is unlikely that the dollar will be the world's saving grace yet as I don't really see a new Shanghai Accord forthcoming.

However, I think there is a window of opportunity for a weaker greenback or a less stubbornly hawkish Fed combined with a weakening but not collapsing US outlook. I could even recommend to buy the eurodollar at 1.13 with the stop at the year's low.

I also think that emerging market (EM) equities will benefit from the softer US and softer dollar outlook without collapsing activity. And I would now look to buy EEM dips.

I think that the Fed's data dependency means that there is a window of opportunity for the belly of the US Treasury curve to catch up to a weakening outlook and softer asset prices. You can see this on Chart 16.

And I actually continue to recommend front-end flatteners – that will be long 5-year versus short 1-year – which will eventually invert and potentially add another 50 basis points to go. I think that still is my A trade to express the late cycle slowdown.

I will also look to rebuild short risk via outright shorts in credit or equities. Because I think they need to reflect the normalization in interest rates. And, really, the name of the game is payback time. I think that's something we have to bear in mind. Lower equities, wider spreads. That does not necessarily reflect an immediate collapse in the outlook, but it also reflects the fact that we need to get out of super-easy money.

Erik: Juliette, I really want to ask you – you live in London, but you're very much French in descent. The situation that is unfolding in France right now with the so-called "yellow vests movement" has really perplexed me. I do understand that the economic circumstances, particularly for people that are less wealthy, has been very difficult. But, good heavens, the amount of violence and anger that exists.

What's driving this? What does it mean? And what are the market and economic effects and consequences that we should expect as fallout from everything that's going on?

Juliette: That's a great question. It's actually been one of my recurrent themes with far-reaching macroeconomic ramifications across the globe. The point is about the social fracture which is deepening between the "haves" (and the ones who have basically benefited from globalization and financial repression) and the "have-nots."

I think it would be a grave mistake to believe that the French upheaval is just a Franco-francais event. The same malaise has expressed itself using the most readily available means: I think in the US it was Trump; in the UK it was Brexit; in Italy it was the combo of Salvini and Di Maio; and most recently in Brazil it was Bolsonaro.

But I guess that the French have a special thing about being blunt, saying things loud and like it is, rather than going through convoluted ways to express a view. I know this full well, as it's got me in many trouble in England.

The conventional wisdom was that France's Macron bucked the trend. The French President was initially hailed as the representative of a new order, based on multilateralism. But it has now become apparent that Macron marked the beginning rather than the end of a brewing disquiet. Rather than embodying the new world, he represents the chaos between two worlds.

Again, the two worlds is, on one side, capital rich who greatly enjoyed both globalization and central banks pumping up assets in the post-GFC era, and the workers who have been hit by globalization, have seen billionaires grow everywhere, and rampant asset inflation price them out of home ownership or even a decent retirement a little bit more every year.

And they are, nevertheless, the ones being asked to pay for the ecological ravages of growth at all costs, policies pursued over the past few decades.

I think the so-called "yellow jackets movement" (or *gilets jaunes* in French) is very peculiar in that it's not driven by a party or social cohort, but by the intense popular sentiment that the last few decades of economic growth flew way above the workers' heads. Which, by the way, it did.

In France, the spark was a new diesel tax to accompany the ecologic transitions. What's the problem there? Well, it probably is the least progressive tax, firstly. But what is really interesting is the fact that, for all the violence and blockades, the movement is extremely popular. And that's something that is really unseen in France.

So, before the Paris destruction of this weekend, it was 84% backing of the spontaneous movement, which vows, basically, to achieve more equalities through taxes and to rebalance spending power. So, even after the Paris destruction of the weekend, it's still 75% backing.

In my opinion, the French are correctly identifying what their American, Italian, Brazilian, and English peers really have been feeling but could not voice accurately. I think the global malaise really finds its roots in globalization digging a rift between omnipotent multinationals and the powerless consumer. And I think this is not going away any time soon.

Just to go back to the 1789 Revolution in France. It was a far-reaching social and political upheaval which altered the course of modern history by triggering the global decline of absolute monarchies while replacing them with republics and democracies. It is possible that this could be another 1789 moment.

Erik: Juliette, it's fascinating to hear your perspective on this. But concretely, how do we link this malaise that's going on – not just in France but around the world – into the macro world? And translate it to economic forecasts and outlooks?

Juliette: Concretely, I think the upheaval is likely to really spill out into the European elections in 2019. But, against a very large consensus, I don't think it will be by causing the unravelling of the EU or the euro.

I'd like to reiterate, really, that the French movement is not an anti-Brussels or anti-EU movement at all. I think more likely it will lead to more leniency towards increased spending and deficits as Italy becomes less isolated in its stubborn fiscal stance.

Today the French Prime Minister has already announced the temporary withdrawal of the diesel tax and he will also have to loosen his grip on the fiscal purse to restore internal order. So that's – I'm really looking towards more leniency on the EU side on the fiscal side.

And that's really why I started to recommend long BTPs – Italian 10-year BTPs – about two weeks ago. And I still like to hold that.

My other really important conclusion – well, at least it's very important for me – is that the whiff of French revolution is also a big warning shot to central banks because, artificially inflating assets is a boon for the capital rich. But it is really a festering wound for those who have not had a chance to start accumulating retirement assets or even to get a first step on the property ladder.

I really think a return to financial repression risks stoking the populist fire, spreading discontent and frustration. And, therefore, central banks really have to think much longer and much harder before deviating from the normalization path.

Erik: Well, Juliette, I have been taking notes throughout this interview because, at our event in Vancouver, I get to moderate a discussion forum where we're going to have you and our other five speakers onstage all at the same time. And I'm already thinking of ideas for topics. I'm really looking forward to seeing you debate and discuss with our other speakers.

But why don't we come back to your own presentation at MacroVoices Live. What are you planning to talk to us about?

Juliette: As I mentioned earlier, I would really like to cover some of my favorite global leading indicators. But what I will do is what I do for JDI Research reports two to three times a month, and basically that is covering subjects that are most relevant to the investment landscape in January and help your listeners extract returns.

Most importantly, though, I would like mention that I'm really looking forward to meet very smart investors and exchange views, as well as learn more about their interests and real investment objectives.

Erik: Well, you'll have plenty of opportunity to do that. That was actually the biggest feedback we got out of Toronto was people wanted more face time with speakers. So we've got two receptions – one before the event and one after the event. And plenty of opportunity to meet the attendees. So we're really looking forward to seeing you there in Vancouver.

Before I let you go, though, please give us a quick summary of what you do at JDI Research – what products you offer and what you have available to our MacroVoices listeners.

Juliette: Really, what I try and provide is research and strategy dedicated to traders. My main concern is their benefiting from my views, my macroeconomic views. What I provide is two different services.

One of them is via JDI Research reports, which I publish about two to three times per month and also update via email constantly on the basis of any game changers or any new ideas etc.

I also have a service which is dedicated to CIOs and portfolio managers where I'll be every day on Bloomberg giving you the whole thought process between one report to the other on any kind of event, data, big market moves, etc.

I'll be happy again this year to give an interesting discount for either service to MacroVoices listeners. And that will be available until Christmas and also means that those interested would receive access to all historical reports.

Erik: Fantastic. So, for people who want to take you up on that, how do they contact you to find out more about what you're offering?

Juliette: My email is juliette.declercq@jdiresearch.com. And you can find that through our website jdiresearch.com and just press the Contact button. And I will personally reply to anyone who is getting in touch.

Erik: Well, Juliette, we cannot thank you enough for another fantastic interview. And I particularly look forward to seeing you next month in Vancouver and getting you on the stage at the same time with our other guests. We're going to have to leave it there in the interest of time.

Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.

On that note, we're going to need to leave it there, Julian, but I Really look forward to seeing you in January in Vancouver. Patrick Ceresna and I will be back as MacroVoices continues right here at macrovoices.com.