MACRO Voices
with hedge fund manager Erik Townsend

Juliette Declercq: Questioning the Fed's ability to service its inflation mandate

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Erik: JDI Research founder Juliette Declercq joins me next on the program.

Juliette prepared an outstanding chart deck for our listeners, which I strongly encourage you to download. It will be used throughout this interview. You can find the download link in your Research Roundup email. Or, if you're not registered yet, just look for the red button on our home page next to Juliette's picture that says Looking for the Downloads.

Juliette, it's so great having you back. It was great seeing you live at MacroVoices Live in Vancouver back in January.

Something that you had been talking about, really, all through 2018, you brought up again in Vancouver in January: inflation. And at the time, Juliette, when you started to bring it up, it was very much out of consensus. Now suddenly everybody is talking about inflation.

So what's up with inflation? What's going on here?

Juliette: Erik, I think you're right. Everyone is all over inflation today. But the real value was to be talking about it last year and to reiterate the same theme earlier this year – to forecast, basically, a risk parity "feast" which is currently ongoing. There is nonetheless still value in going through my thinking here to explain the ongoing risk parity explosion.

So consider the 2019 supposedly dovish pivot at the Fed. Central banks have allowed financial markets to become a by-product of real rates as long as earnings growth remains positive (or, basically, as long as an earnings recession is expected to be shallow).

So financial markets effectively have a lower equilibrium rate (R*) than the real economy when rates are going down. And of course the opposite was true in 2019 when financial markets plunged faster than the economy because rates were going up. So that's the simple explanation behind the fact that financial conditions loosened dramatically this year whilst market-based inflation expectations are still very much struggling to recover.

In other words, and this was the subject of the late March JDI report, don't be fooled by equity markets. There is no real reflation.

This is a theme the Fed has obviously finally picked up on with Powell now openly admitting

that, since officially adopting the 2% target in January 2012, the Fed has not achieved this convincingly or in fact in a symmetric way.

What I would like to demonstrate here is that the Fed – much like its G3 peers, namely the BOJ and the ECB – is already failing its inflation mandate. It shouldn't be a fear. It should be a realization that it's already happening.

Ahead of the Chicago inflation framework conference on June 4 and 5, there has been talk about moving from a bygones policy – which basically ignores the fact that the 2% target may have been missed in previous years – to a makeup policy whereby previous misses would mean targeting a higher target.

Personally, I think it is the perfect time to remind our readers and your followers of the fact that moving to a more ambitious inflation policy is delusional when the commitment to the current target and inflation framework is already in question.

Inspired by the Chicago Fed's Evans' comment on April 15 that a symmetric 2% target should entail running modestly above target 50% of the time, I have illustrated on Chart 1 the Fed's inflation plight on a histogram of year over year core PCE monthly outcomes since the target was formally adopted in 2012. (Note that the explicit notion of inflation targeting appeared in FOMC meetings in the mid-1990s.)

If you look on Chart 1, you can see in blue a normal distribution with a mean and standard deviation that matches the one of the core PCE series since January 2012. And the orange normal distribution has the same standard deviation, but a 2% mean. So it's the distribution of outcomes that should prevail if the Fed was doing its job.

The obvious observation here is that the outcome of the Fed's inflation policy framework has been wide of the mark of its stated goal in the past decade, about 35 basis points. It is especially concerning, as far as the Fed's credibility is concerned, that pre- Global Financial Crisis we had a distribution with a 1.73 mean when the target was actually understood to be 1.5.

In other words, the Fed's inflation performance has slipped away further from 2% since the target was consecrated.

So if you believe that the Fed can affect inflation (which is another discussion), well, the suboptimal post-GFC inflation outcomes suggest that monetary policy has been too tight in the aftermath of the crisis.

Erik: Okay, Juliette. Now that we have established for the math majors that you've made some academically defensible arguments, let's translate some of this to plain English and explain other reasons, if you have some, that might gain conviction on why the Fed is failing in its mission to achieve its inflation objectives.

Juliette: Well, Erik, I am very convinced that inflation expectations are slipping away. And I'll name and show you a few reasons here. After all, what I like at JDI Research is for clients to not take my word for what I'm saying but being able to actually show it through a chart. So let's go through a few charts.

Firstly, on Chart 2, you will see that, even with realized inflation recovering since the 2014 energy slump, survey-based expectations are collapsing. And this is a big deal because inflation expectations are normally reflexive, which means that people expect what was delivered in the past two to three years.

Even worse, on Chart 3, is the fact that low inflation outcomes have become increasingly predictable and that's ensuring that expectations are not only low, but they are very well anchored. You will see on Chart 3 that uncertainty about the inflation outlook has been trending down in line with increasingly more restrictive Fed accommodation.

My view is that, in the past decade, the Fed has been too focused on normalization at all costs and the risk to financial stability.

Chart 4 shows that the Fed has consistently confused brief periods of 2% inflation with achieving its end goal. And you will see that on Chart 4.

It's true that inflation has increasingly been a global phenomenon and constrained by deficient final demand and an overall zero-sum game. But when you are the Fed, low inflation is not a fatality. And I strongly believe that the unduly restrictive Fed stance has cemented the low-forever medium-term inflation outlook.

In this respect, the 2018 episode was especially detrimental. Powell's Fed was pushing a dot-plot of interest rate projections wildly out of whack with the macroeconomic outlook, e.g. falling long-term growth potential and inflation expectations depressed by years of low realized inflation. So it was always going to lead to a forced pause in the hiking cycle.

However, achieving a pause that refreshes, which is what many macroeconomic pundits are looking for this year, will necessitate a more decisive policy move. And this is something that is perfectly illustrated on Chart 5.

Erik: Okay, Juliette. If I understand correctly, the Fed is moving toward acknowledging its failure to meet its inflation mandate. But will be prepared to act to achieve the declared objective?

Juliette: Look, Erik, the minutes of the March meeting were unambiguous in highlighting the downside risks to inflation. Meanwhile, so you will see on Chart 6, the number of FOMC participants seeing upside risks to core PCE has collapsed to a big fat zero.

So, with Core PCE at 1.55 versus a 2% target, and no upside risk to inflation, in a "symmetric" policy framework, don't you think that immediate action should ensue? I mean, if all FOMC participants saw upside risk to inflation in the vicinity of 2%, I have no doubt that hikes would follow suit.

A crucial challenge for the Fed has been the lack of inflation responsiveness to tighter labor conditions and basically no wage spiral. Simply put, it suggests pursuing much more aggressive monetary policy to shift the distribution of core PCE outcomes towards the target. In an inflation-targeting framework, it suggests scrapping the positive effect of the labor slack component of the Taylor rule when at full employment.

This is a framework that has allowed me to argue in 2018 for a terminal rate just above 2%. Now we have core PCE just below 1.6%, my prediction is clearly validated because my modified Taylor rule would dictate that interest rates should be adjusted to 1.90% (assuming a circa 50 basis points real R*). So if the Fed wants a chance of achieving its 2% target sustainably, it basically has to cut 50 basis points.

In fact, taking the inflation framework seriously would mean adopting a higher target in line with what Evans was saying, even if it's just temporarily. Which will actually dictate a reversal of as much as three hikes from 2018.

Erik: Okay, well if that's the case, what's holding the Fed back?

Juliette: Well, this is the really interesting part of the discussion about inflation. What would happen with a shock interest rate cut?

I think what would happen is that term premia would go screaming higher and re-steepen the yield curve. And this is really the problem.

Ironically, in its quest to promote financial stability, the Fed has been breeding instability. And this is because sacrosanctity certainty awakens the wildest speculative animal spirits. And this is something you can see on Chart 8 where VIX next short positioning is basically at an all-time high.

On Chart 9 you will also see a great illustration of how the Fed's faint-hearted commitment to a symmetric inflation target has rigged the inflation game and basically cemented a lower-for-longer inflation outlook, which has allowed long-term term premia to collapse and given risk assets a very welcome boost in a heavily financialized economy.

My worst fear is (and I am part of the lucky ones because I have savings) that my savings generate no income when I retire (basically that rates have collapsed to zero). And my other fear is for those same savings will be depreciated by central banks pumping up the assets I aspire to buy – for example, properties.

The issue today is that lower rates no longer steepen the curve or raise inflation expectations, so the positive effect of lower rates for purchasing power is completely offset – and, in fact, more than offset – by higher asset prices from lower-for-longer yields and therefore much lower affordability.

I have been trying to source a mortgage recently, and I guarantee you that lower rates are not helping anyone that is not already rich. No bank will lend you money unless you can afford to repay the capital. And this is leading to nothing less than a return to medieval Europe feudalism, which was structuring society around relationships derived from the holding of land in exchange for service and labor. Lords hold the land, and vassals pay rent.

Anyway, the crazy thing is that, as I contemplate the upcoming slowdown, I am worried about yields collapsing, asset prices rocketing, and becoming a vassal in a medieval system. This leads me to feel comfortable chasing asset prices higher, which is really crazy ahead of a slowdown.

What's happened, basically, is central banks have rigged the inflation game and caused a paradigm shift in asset price dynamic that has now become their main problem. Whilst I will continue to monitor the health of the global economy and its components like a hawk, the biggest macroeconomic risk today is not an economic downturn that will trigger a financial market crash – but it's the financial crash that would cause an economic downturn.

Risk assets have increasingly been priced on the firm conviction that inflation risks were indisputably skewed to deflation. And this has led to the high sensitivity of risk-assets to bond yields – which is basically the hallmark of financial repression and asset inflation – and it is today's chief vulnerability. Think about that.

Including real estate assets, global risk assets are worth about five times the size of the global economy. The extreme vulnerability of risk asset valuations to higher term premia makes higher yields ultimately self-defeating.

And that's the reason why no Central Bank will successfully reflate and normalize monetary policy in this business cycle. The Fed is the next one to fall.

A Fed-induced inflation shock (for example, a large pre-emptive cut that would cause term premia to mean revert) would cause bond yields to rise substantially and risk asset valuations to tank.

Ahead of the much-awaited June Chicago conference, I warn you: Be careful what you wish for, because inflation at this point would more likely be the problem rather than part of the solution. And that's where The Fed is stuck at the moment. It has to play not to lose, rather than play to win. It results that it can't win.

The specter of inflation when asset valuation depends on low rates is probably one of the reasons why the Fed will choose to turn a blind eye to its evident failure: The failure to reflate

the real economy has the desirable side effect of reflating financial assets and keeping what I would call the fake economy afloat.

Consequently, much as I expected tighter financial conditions to eventually sound the knell of the 2018 hiking cycle, I expect the break higher in the dollar to collapse inflation expectations and eventually blow the whistle, signaling the start of the Fed's cutting cycle. In the meantime, the Fed will remain reluctant to cut. (Ironically, ebullient risk assets, due to the ongoing disinflation, will be a further hurdle to rate cuts.) And that means that the Fed will remain behind the curve, reactive rather than proactive, and therefore too restrictive to promote global reflation.

Erik: Okay, so it sounds like on the whole your views are very much in line with mine, which is that the Fed has basically painted themselves into a corner. They've put themselves in the business of propping up asset markets using money conjured out of thin air.

That has successfully changed the subject from the 2008 crisis to asset prices are going up, which took everybody's mind off of our other problems. But it's now put them in a situation where they have no choice but to continue doing things to keep assets propped up.

So what's the policy path ahead, given those circumstances?

Juliette: So, as I expected, Fed officials have started to contemplate inflation thresholds for rate cuts. And that's including a scenario where inflation drifts lower even without growth faltering. I don't expect the inflation outlook to improve, so we will easily fall towards 1.5% for longer, which Evans defined as his condition for a cut.

Honestly, with final demand still subdued globally (and also, really, in the US), inflation has been the mirror image of commodity and FX moves, with the 30%-plus rise in the dollar in the aftermath of the Great Financial Crisis acting as a binding constraint to inflation.

We've had a brief dollar selloff amidst a synchronized global upturn from 2016 to 2018 and it's been a main source of reflation (via core goods reflation). But it's now turned into a deflationary force, as you can see on Chart 10.

Now, looking towards China, whilst we got a powerful stimulus which has stabilized activity in China, producer price inflation remains muted there. And that means that China will keep being a global deflationary force this year.

(Chart 12) Going back to the US, productivity growth has more than offset wage growth, which is really keeping a lid on unit labor costs [ULC] and pushing cost-push price pressures down.

(Chart 13) If you go back to the leading indicators from surveys, and we just got the ISM survey, for which price paid came out at just 50, we're still really looking at a downward path for prices ahead.

Meanwhile, even if energy has been going up so far this year, energy prices remain a deflationary force year over year. And that's visible on Chart 14.

All in all, I don't believe a rate cut is imminent. However, as inflation softens, real rates move higher and monetary conditions are becoming more restrictive despite the Fed's pause. And that's really been the key non-consensus view this year from JDI Research, that this is not a pause that refreshes but the Fed is already too tight and increasingly restrictive. So that will drive the dollar to continue to appreciate and add further downward pressure on US and global inflation, and the longer the Fed waits and the deeper it will have to cut later.

A strong dollar is the one thing that will eventually force the Fed to cut. So I'm looking for a first cut probably in September, which would fit well with the June 4 and 5 review of the inflation framework.

And that's the reason why I stick to my recommendation to be long dollar versus euro and South African rand. And I also warn against long EM equities. And I also still very much like long fixed income from the US and Europe first of all.

I also expect gold to outperform as the global FX war will intensify when it becomes apparent that the China bounce will not defeat global deflationary forces this time. I also don't see a Fed inflation big bang as likely, which means that the Fed will not be able to spur reflation.

And the result should be an endless inflation-free soft landing, allowing financial assets to continue to re-rate amidst financial repression.

So the question, of course, is when does the cycle end? Well, I think it could end with an MMT-crazy 2020 US president triumphing over disinflation. Or, basically, with the Fed joining its monetary policy peers in running out of potent policy tools after a collapse in the yield curve.

Erik: Okay, Juliette. So, on the US dollar specifically, there is a large consensus among a number of macro pundits that a China-led bounce in global growth combined with a Fed pause could lead to a weaker US dollar.

Now, they've also been proven wrong so far, but most of them struggle to understand why. What's your take on this?

Juliette: So their prediction really assumes two things which I think are both wrong. Firstly, as I explained earlier, I think the Fed is still restrictive, which makes the dollar irresistible.

And secondly, China-led global reflation is equally questionable, although the missing link in the global reflationary equation really is the weaker dollar.

Erik: Okay, Juliette. What's your take on risk then?

So that's my framework. With global central banks traditionally backward looking – they're basically focused on hard data and that's what data dependency means) – cyclical assets have been surfing on a combination of weak coincident data and strengthening leading indicators.

So we've been so far this year in the very sweet spot for risk parity because of data dependent central banks becoming increasingly dovish as profit expectations recover with leading indicators. So that's both positive for bonds and stocks.

Now, the weak spot for risk parity and risk assets will return when data start strengthening meaningfully enough to lead central banks to adopt a less dovish bias and/or leading indicators will stop improving.

Today, my main concern really is that the pick-up in leading indicators is not only fully discounted, as you can see for yourself on Chart 15, but it's also quite indecisive, as you can see on Chart 16.

On Chart 16, you can see IFO and the OECD leading indicators, and they're kind of my favorite leading indicators. Gross exports represent about half the economy, which makes the country super-vulnerable to oscillations in global growth.

And, because those exports are closely matched to the structure of the global economy as far as GDP weight by regions are concerned, the IFO survey, which comprehensively surveys real German businesses (rather than "experts"), is one of my favorite coincident/leading gauges on global activity.

So last week's release showed that March's gentle optimism regarding the rest of 2019 had already evaporated. Not only the current assessment component (which is the coincident data) showed that the German economy continued to lose steam, dragged down by manufacturing and trade, but more importantly, (as highlighted on Chart 16) expectations also faltered.

The truth really is that the Chinese credit impulse, which everybody is looking at to say that global deflationary forces will be defeated, is probably overstated as far as its positive effect on the world is concerned. And especially the non-US world.

And there are a few reasons for that.

Firstly, because consumption (which is what is favored in China at the moment instead of infrastructure spending) is much less important and safe.

Secondly, because China's credit impulse is becoming less efficient – if you consider a report issued by the IMF last summer, 1 trillion yuan of credit was required to generate 1 trillion of output in 2008; in 2017 (which is the last available data), the same output would be achieved with 3.5 trillion yuan of credit.

So, in a nutshell, you need a lot more credit to achieve the same outputs. And even more if you want to achieve the same effect for the rest of the world, which would be reflected in say imports from China.

Thirdly, there is one thing that we're not talking about today is the fact that China's credit impulse for the rest of the world is probably going to be a false signal due to the China and US trade deal.

We are at the moment in the last lap of the China/US trade negotiations. And I think negotiators are in Beijing this week and they will be reconvening in Washington next week.

Whilst a truce is largely seen as positive flow for global trade – and it's true that it is as far as uncertainty is concerned – it is really a double-edged sword as far as trade is concerned because the Chinese economy is unlikely to open much further.

Therefore, global demand will remain deficient and the rest of 2019 will be about discovering that global trade is really a zero-sum game from which the US is trying to carve a much larger share.

So what I think will happen is that there will be initially a strong crowding out effect affecting Brazil for soybeans and agriculture products, Australia for gas, EU and Japan for cars, EU for airplanes, and Japan, Korea, Taiwan and (again) EU for electronics. Which will in the end promote a stronger dollar and eventually just result into a global reshuffling of global trade.

So the bottom line is that the trade deal initially comes at the expense of other exporters, which means that a leading indicator that has in the past suggested increased global activity may now be a false signal for markets other than the US.

In fact, the disproportionately positive effect on the US means that the budding global recovery will be reminiscent of the 2018 dynamic (e.g. unsynchronized). And this will add to already strong appreciation pressures on the dollar and will in turn suppress global liquidity and hinder global reflation.

So I am looking for a stronger dollar, lower yields (front-end US, and France ten-year) for reflation forces to subside and force the Fed to cut. And I also think that optimism about the China stimulus is overdone and increasingly discounted, which has led me to recommend a short copper trade last week.

I think the positive effects of the China impulse on the US will be countered by a stronger dollar. And for the rest of the world, it's largely becoming a false signal.

Erik: Juliette, I want to come back to inflation, because this is a topic that's very much been on my mind in recent months. Although I think I'm looking at it not necessarily differently

than you are but maybe in a different timeframe.

So let me describe the concerns that I have. And I'd really like to get your feedback because I know that both the social and the economic implications of this are something that you think a lot about.

Here's how I see things. So many people thought that quantitative easing was going to create runaway inflation and it was going to hyperinflation, the end of the world, and so forth. Of course, they simply failed to understand that the way quantitative easing works is that it creates bank reserves. It doesn't pump money into the real economy, it pumps up asset prices. And it certainly has achieved that.

And, as you said, it's created this tail-wags-the-dog market where, effectively, it's not that the market is signaling what's going to happen in the economy. The market is causing what happens to the real economy, which I think is a very bad place that we're in.

But a bigger trend than that even is I think we've gotten to the point now – and Neil Howe writes about this in *The Fourth Turning*, telling us that what we can expect in periods of history, like fourth turnings as we're in right now, is society tends to pivot from one extreme to the opposite extreme.

And certainly in the United States, regardless of whether you are a supporter of President Trump or you're not a supporter, you cannot deny that he is an unconventional leader. He's clearly not the norm.

And the potential that I see in the 2020 election is we could pivot to an opposite leadership. Let's say it's Bernie Sanders as president and Alexandria Ocasio-Cortez is vice president and we end up with Stephanie Kelton, the spokeswoman of MMT, as the new Fed chairwoman.

In an environment like that, it seems to me – and, frankly, I think we're headed there for a lot of very valid reasons – I think that the people who have been on the wrong side of wealth inequality injustice are rightfully upset.

Now, personally, I think capitalism is not the problem. I think it's the cure. I think that if we were to get rid of cronyism and replace it with honest capitalism, that would be the solution.

A lot of people don't see it that way. They think we need to move to a lot more social spending. They think we need to move to universal basic income, free college tuition, forgiveness of student debt loans, and various other things.

Now, those things, they do pump money into the real economy. They would be extremely inflationary.

I think we could be coming into a political change that – certainly the populism in your own

country of France has shown us that the people of France are just fed up, especially the working class, are fed up with economic conditions. They're demanding a change.

And I'm afraid the change that we're likely to get is not one that's really going to solve the problem, but it is one that's going to unleash massive inflation and maybe do more damage with that inflation than the money that was pumped into the economy was intended to do good.

What do you think about those concerns? And do you think I'm right that if we were to get to helicopter money at some point that that's got to be extremely inflationary for the broader economy?

Juliette: That's a great question. So the first part of my answer would be that we've got the yellow jackets in France, but the fact is you have got education in France, free health care, and there is absolutely like no inflation. So that's the first element of answering that.

In the US itself, I think there is very much room for a little bit more socialism without completely departing from capitalism. After all, the US is the last emerged country not to offer maternity leave for women, which I think should be a God-given right.

I actually wrote an op on that last month, and it was called "Is There a Cost to Socialism?" And, really, my conclusion was that there is a lot of space for more socialism in the US, as you say. More equality on education, more equality on healthcare. And I really don't think that would be inflationary. In fact, that would be one thing that could probably add some credibility and rebalance inflation expectations.

I completely agree with you that – I see more and more even die-hard Trump supporters thinking – you have to be really rich to really continue to support the kind of running up assets at all costs that is currently going on.

So I see more and more inequality becoming a problem. And I could very much see voters next year going for the other side of the spectrum and basically voting for someone that's going to crash the stock market, in a way. And by "crash" I don't mean like 50%, but just more uncertainty, higher risk premia, etc.

But, yeah, basically my conclusion was that you don't have to get to MMT to just spend more in the US without risking much on the cost side. Because you'd probably get – as long as rates are lower than nominal growth, you would basically get a lot of benefits from higher spending.

Erik: Well, we didn't get to MMT in detail in this interview. Maybe we can bring that up next time. I think we've got you scheduled a couple of weeks out in our new MacroVoices Premium All-Stars format for another short-form interview, so maybe we can come back to that then.

Before I let you go for today, though, please give us a quick rundown. When I first met you, you were very exclusively an institutional advisor. You really only offered your advisory services to professional organizations that were primarily hedge funds and other major traders.

I'd like to think that MacroVoices may have helped to make a difference in that. I know that you have opened your services up to some of our high net worth listeners. So give us a sense of what you do there and particularly with emphasis on what you offer to high net worth individuals, family offices, and others that don't meet the traditional profile of an institutional advisory client.

Juliette: What JDI research offers, really, is a unique trade-driven approach to macro research. And what I mean by "trade driven" is I really mean everything I write is written for investors and traders in a view to waste as little of their time as possible. And giving them the deepest understanding of what's going on and what is likely to happen.

I still mostly aim at professionals, but have made high net worth investors quite happy, I think, in the past two years as well by opening up the product to them.

So, really, what I ought to say is get in touch if you would like to invest in your investment process and learn about macro in the easiest, clearest way whilst making decisive forward steps financially.

I don't really believe that real value is ever given for free (apart of course on MacroVoices), so don't contact me for freebies. But I'm offering by-yearly a deep discount to MacroVoices followers for the next two weeks. So do get in touch for this if you're looking for guaranteed real value. What I mean by "guaranteed real value" is that I'll refund you for up to eight weeks if you are disappointed by the product you are getting.

Erik: And what's the best way for our listeners to contact you, Juliette?

Juliette: At juliette.declercq@jdiresearch.com. Or you can visit my website www.jdiresearch.com and basically just click on the link there and get straight to me.

Erik: And, listeners, as a little bit of guidance, Juliette's institutional product is in the 40 or 50 thousand dollar a year range. It is cheaper, for sure, for individual high net worth investors. But this is not a few hundred dollars a year. If you're in that ballpark, probably better not to waste your time or Juliette's. But by all means reach out to Juliette. And, again, you can reach her at juliette.declercq@jdiresearch.com.

Juliette, thanks so much for joining us today on the program. I look forward to seeing you in just a couple of weeks on our new MacroVoices All-Stars format. Meanwhile, Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.