Fidelity Compass

Global Macro – What's Moving the Markets and What Lies Ahead

Jurrien Timmer, Director of Global Macro

Pamela Ritchie, Host

[00:00:34]

Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Earlier this week, fully vaccinated Canadians began crossing the land border to the United States for the first time since the onset of the pandemic in March 2020. The symbolism of this reopening couldn't have been timed better. Consider last week's stellar October payrolls report coupled with the passage of President Biden's $1 trillion infrastructure package, it wasn't really a huge surprise that markets responded accordingly with new record highs through the beginning of this week. Being tempered a bit right now, certainly due to the CPI print out today that showed October inflation hit the highest point in more than 30 years.

What could all of these moving parts, particularly on the inflation front, mean for markets in the weeks and months ahead? To share his analysis of the latest data and to discuss what is next for monetary policy, we're very happy to be joined today by Fidelity's director of global macro, Jurrien Timmer. Hi Jurrien, great to see you.

[00:01:30]

Jurrien Timmer: Good morning. Nice to see you, Pamela.

[00:01:33]

Pamela Ritchie: Great to see you. I'll ask everyone who's joining us here to feel free to send in questions. There's a Q&A function there on the side of the screen. Just send questions and we can put those to Jurrien throughout the next 30 minutes or so. Let's begin with the CPI print. Shelter was a surprise. We saw the 10-year yield rise a bit. What stood out for you?

[00:01:57]

Jurrien Timmer: This has been an interesting report and not necessarily in a good way because it's hard to explain away. The Fed has had the narrative and actually the markets have been agreeing with that narrative for the past six or nine months or so that, yes, inflation is coming but it's going to be transitory. So supply chain bottlenecks, base effects, inflation coming off of a very low base because of the lockdowns and then the lockdowns and everyone starts travelling, buying stuff, going places. So the inflation surge that we've been seeing now really for the past six plus months has been justifiably explained away to some degree by monetary policymakers as transitory and that once those supply chain bottlenecks get resolved, which eventually, presumably they will, then we go back to normal. That's been the Fed's narrative and it's been the market's narrative. If you look at the TIPS breakeven spread, it's been 2 to 2.5%. So nothing really earth shattering there. I mean, higher than it has been, certainly, but it's not like the TIPS market is all of a sudden breaking out to 3 or 4+%.

[00:03:12]

But now we got the CPI print this morning and it is far harder to explain this one away. It is much more broad based. It's much more related to owners' equivalent rent. The housing market in general, they're still supply chain issues but it's not all about that. It brings to mind something that you and I have discussed before which is this very specific fork in the road, if you will, in terms of where we are in this cycle with regards to the Fed trying to normalize policy off of the zero lower bound.

[00:03:53]

Pamela Ritchie: You used the word, I think, in your war report that there's been a round trip and yet we're still not seeing this. I know one of your charts speaks [indecipherable - crosstalk].

[00:04:05]

Jurrien Timmer: We can go to slide 1. Our conversation prompted me to do a follow up which I haven't finished yet but it's interesting, if we look at the economy, whether you measure the output gap as the difference between potential GDP growth and actual GDP growth, with potential GDP growth being the sum of productivity growth and labour force growth. The CBO has those numbers and has maintained them for a long time, so you can measure the output gap that way. Another way to do it is in this chart and that's just to simply measure the unemployment rate and compare that to what's considered full employment because there's always some unemployment, frictions, people moving around, et cetera. The spread between those two rates is very much like the output gap. That's the grey line in this chart. You can see that before the pandemic, it was at -1, which means that the economy actually was running beyond full capacity. The economy was pretty tight at that point. Then, of course, the lockdowns happened. That spread went to 10.3%, which I think may be the highest ever, at least as far as the recorded data goes. Maybe during the Great Depression, it would have been higher but there were no data for that then. We have completely round tripped back to essentially zero.

[00:05:33]

A lot of people don't believe this, but the economy basically has recovered fully from the lockdowns. In that sense, it has followed more of the natural disaster type of analog historically than your typical recession. The reason why this is important is if we go to the next slide, that should be reflected, I would think, in what the Fed is saying it's going to do and what the market says the Fed is going to do. That is only half true.

If we look at the bond markets, the black lines there is the 10-year Treasury yield in the U.S. The orange line is the Fed funds target rate, which is the official policy rate in the U.S. Then we have the dot plot. Those are the purple dots. That is what the Fed is signalling to the markets every quarter when it has its big two-day meeting and the last one was in September. That's what the Fed is signalling to the markets in terms of what it's going to do to policy. These dots represent the 16 FOMC members individual expectations of where the Fed is going to be at the end of this year, the end of next year, the end of 2023, '24 and then over the very long term. What the dots show is that the Fed is going to go to about 0.5% from zero next year and then to about 1.25% the year after that and then about 2% in 2023, that would be.

[00:07:09]

But the market does not seem to agree with this. The dark blue line is the Fed funds futures curve, so that's the bond market voting with its feet, if you will, in terms of saying, this is what the Fed will do and the market agrees with the Fed for 2022 and it kind of agrees for 2023 but beyond that, the market is basically saying that the Fed is not going to raise rates as much as the Fed says it's going to and that's an interesting disconnect.

I'll show you the next slide, slide 3, just another way of showing this but maybe a more intuitive way, if you look at what we call the natural rate or the neutral rate, so R-star is what it's called, that's the grey line, it is a real rate of interest. It's not a market rate. It's a theoretical construct that essentially says this is the rate at which the economy is in balance, that would warrant a neutral monetary policy. That grey line is just above zero to about 0.5%. As you can see, it's been going sideways for a number of years. The blue line is the real Fed funds rate, the funds rate minus the inflation rate and I use a smooth two-year inflation rate here. The orange line is the shadow real Fed funds rate, which is a hypothetical rate that the Atlanta Fed produces to account for balance sheet shenanigans, if you will, asset purchases and the like.

[00:08:41]

What you can see is that the Fed has basically never been more accommodative as it is now. It's even slightly more accommodative as it was in the aftermath of the financial crisis. That dotted blue line way at the right of the chart shows that the Fed funds futures curve adjusted for inflation ... and I'm assuming 3% for now, although that obviously today seems conservative but let's just say 3% for the next three, four or five years. It shows you that the Fed is not expected to even go back to neutral, even though the economy has fully round tripped back to full capacity and even though inflation is running hot now for a lot longer than what might be considered transitory. It's just an interesting disconnect and it makes you wonder what the repercussions are going to be. There's two ways that this can resolve. Either the market is wrong about the Fed and starts to agree that the Fed actually is going to return to neutral, at least, and that means that rates would have to rise, the curve would flatten because the market would need to price in more rate hikes.

[00:09:57]

The alternative scenario is that the market correctly sees that the Fed simply cannot return even to neutral because we're living in an era of very high debt levels and economies, not only in the U.S. but in Canada and elsewhere, economies that are highly levered to low rates and that economic and financial conditions simply do not warrant a Fed returning even to neutral, let alone going to restrictive policy. The implications of that is that scenario might allow inflation expectations to really become unanchored and to become more structural and then there's a whole menu of things we could think about at that point in terms of how we would invest, what would happen to real rates, what happens to gold prices in that scenario. It's just a really interesting fork in the road here.

[00:10:57]

Pamela Ritchie: It's really interesting and it's really interesting today, as you say, that this fork in the road perhaps has lightened things a little bit more, lighting the path a little bit of the difficult decisions. Some of the ways I've noticed it's being explained away maybe is still this focus on services are not back up and running, the supply chain issues and the associated inflation that are to do with goods. That's not the biggest part of the American economy nor the Canadian economy so there's still room. There's still time, wait and adjust. One of the bigger questions, as you mentioned, because of this indebtedness, inflation can be let run but how high? Three percent is a comfortable place to be, perhaps? I don't want to make you say a number but can you say a number?

[00:11:49]

Jurrien Timmer: Over the past 10, 15 years since the financial crisis era, we know that inflation has been... The Fed has undershot its inflation target of 2%. You can see that in the TIPS market. We can pull up slide 6 that shows the TIPS breakeven. The Fed has a dual mandate, full employment and 2% inflation. It has underperformed, for the lack of a better term, its inflation target. A couple of years ago, it switched to AIT, average inflation targeting, which basically says, if we've undershot inflation for so many years, we're going to let it overshoot if inflation runs hot so that the average of the two gets back to 2%. So the Fed has given itself plenty of room to allow inflation to go above 2% without having to chase that by immediately slamming on the brakes. I think the Fed is in a good position in that sense and I think that is a correct, justified approach.

[00:13:04]

When I look at the labour market, which is very, very tight, there may be seven, eight million people unemployed still technically in the U.S. but there are 11 million job openings, so the labour market is very, very tight. The housing market is on fire. You in Canada know all about that, of course but in the U.S., it's now a similar situation.

Those two forces seem to be the places to look for when you think about, okay, could inflation become more structural and whether that's 2.5, 3, 3.5, 4 … I don't know the answer. Remember, there's always inflation and deflation happening at the same time and we have a powerful deflationary wave from technological innovation, from demographics. That's a very important one as well. We had one from globalization, although that globalization is kind of in reverse now. We always have to look at all of the different structural forces, but I think it's not a leap to say that maybe we're not going to be back at that 1.5 to 2% inflation in terms of the longer wave going forward and that we might be at 3 or 3+. Then it's just a question of what the Fed does about it.

[00:14:23]

My sense is that we're living in an era of financial repression, not unlike what we saw in the 1940s, where the debt-to-GDP went up a lot. It went up about threefold to 120% of GDP back in 1946. The Fed, which was not yet independent at the time. It is so now, of course, but back then it wasn't. The Fed was tasked with essentially monetizing that debt, so the Fed increased its balance sheet from 1942 to 1946 tenfold and capped bond yields at 2.5% and protected that 2.5% threshold by essentially doing QE. That, to me, is kind of a blueprint for where we are now. The Fed, of course, isn't beholden by the Treasury but still the Fed and the Treasury, with the Treasury run by a former Fed person, I think they're kind of cut from the same cloth. My sense is that economic conditions in terms of where we are in terms of indebtedness kind of keep the U.S. economy and the global economy fairly levered to low rates. I think that's going to prevent the Fed from chasing inflation the way it might have in the past.

[00:15:46]

My sense is that higher structural inflation, as long as it's not too high, but certainly 3, 3 1/2% is something that the Fed could probably tolerate and the bond market perhaps as well. Coming back to the inflation numbers, the bond market is not crying foul here. The bond vigilantes, maybe they've all retired or something but the bond market, even though it's reacting to these numbers, the 10-year yield is still at 1.5% which is well below where the inflation rate is. Until the market really starts to force the Fed's hand, I think the Fed has some luxury here to take it relatively slowly based on where we are in the cycle.

[00:16:36]

Pamela Ritchie: There's a question rolling in which was basically a question on cryptocurrency. If we're heading towards more sustained inflation, what are your thoughts on cryptocurrencies alongside more traditional inflation hedges? Just very quickly before you get to that, does it matter who runs the Fed?

[00:16:53]

Jurrien Timmer: I don't think it does. I think the institution, and this does not just apply to the Fed but to people in the Cabinet of the U.S. administration, I think these institutions are so well-defined and are so vast in terms of think about all the people who work at the Fed, the New York Fed, all the economists, my sense is that the institution supersedes the personalities. Certainly, right now when we think about Brainard or Powell, I think people think a little bit too much about the Fed is going to completely change. I think once people get in, even if they have a different set of ideological biases, the institution kind of takes over. If we end up in a day someday where the Fed has lost credibility — and that's not a prediction, I don't think that's going to happen — but imagine if the Fed completely lost credibility and an administration, a president, would have to bring someone in to restore that, then maybe it could matter because then the markets need that but we're not in that enough position at all. If we were, the markets would be acting a lot differently from where they are.

[00:18:16]

Your questions about crypto, maybe we can tee that up by going to slide 9 and talk about gold first because I do view bitcoin as many things but one of them, from an asset allocators point of view, is that as a digital form of gold. Coming back to that fork in the road that we were talking about earlier, there's two ways that this can play out. Either the market is wrong and the Fed is right, meaning the Fed is going to go back to a neutral policy, per the dot plot, in which case the market needs to adjust its pricing, its expectations. That means that yields would rise, the yield curve would flatten, the forward curve would change and you get to the scenario where we often are in the late cycle. We're not quite in the late cycle yet. We're still in mid-cycle but there are hints of late cycle from inflation from the Fed. It can either play out the way it normally does, which is that the Fed is slamming on the brakes to fight inflation, it inverts the yield curve and the market takes notes, gets worried about a recession and that's your end-of-cycle playbook.

[00:19:31]

We're not anywhere close to that. What the markets seem to be saying is that we're not particularly worried about that but that would be one way for this fork in the road to be resolved. The other one, as I mentioned earlier, is that perhaps higher, somewhat higher inflation is the price that the Fed and the markets are willing to tolerate for being in this kind of highly levered economy that requires low interest rates. Maybe the market correctly sees that if the Fed pushes too far, if the Fed goes as far as the Fed is currently saying it will, then the economy would just start to slow and that would provide kind of a ceiling on how high rates can go. That seems to be what the market is saying right now.

If that's the case and inflation continues to run as hot as it has been and it is today with the CPI print that we just saw, then that would strongly suggest that real rates will actually not only stay negative, which is where they are right now, but even become more negative. If that's the case, then gold is probably the biggest opportunity out there because as you can see in this chart, that's the price of gold in the top, it hasn't gone anywhere in over a year. We know that gold follows real rates very closely. That's the blue bars in the bottom and the yellow bars in the bottom, that's on a reverse scales. In other words, the higher that those bars go, the more negative real rates become. These are real rates as measured by the TIPS market.

[00:21:14]

Implicit in this model is the assumption that the TIPS market is an accurate representation of where inflation is, which I would argue is perhaps not the case. We had shown the TIPS chart before, the inflation breakevens are still at around 2, 2.5, which is about half of where the CPI is. The TIPS market predicts out for 5, 10 years and the CPI is a year-over-year change. So it's a little bit apples and oranges. If real rates were to reset to an even more negative point than they currently are, then clearly that has very bullish implications for gold and by extension, it has bullish implications for Bitcoin and crypto in general. The way I look at bitcoin is that it is, among other things, a store of value and it's kind of a newer, shinier version of gold, a more convex version of gold, one that is even scarcer because the gold supply tends to be about 1% per year and the new supply of Bitcoin, as we know through the stock-to-flow model, continues to come down and becomes less and less positive as time goes on. You have Bitcoin as a more scarce version of gold and one that has these very powerful network effects, which gold does not do.

[00:22:39]

When you look at stores of value and what do you do with your capital in a 60/40 traditional paradigm? My answer is the 60, I think will be fine. Other than the really heady stagflation days of the 1970s, equities are actually a pretty good inflation hedge. They're actually a very good inflation hedge. If we are going into a period of structural inflation here, whether it's at 3% or 4% or what have you, I think the stock market will do just fine because the stock market generally has pricing power. Earnings are generally seen or looked at in nominal terms, not in real terms. There is a negative correlation with valuations and inflation but if earnings stay up, and so far they've been very strong, we're just wrapping up earnings season as we speak, then I think the market will do fine. The question is what happens to the 40 side of the 60/40? There we start having a problem because the 10-year Treasury yield, just speaking for the U.S. for a moment, is at 1.5, the CPI is at 6+, the five year, five-year forward TIPS market, which you can see here, or the 10-year TIPS market is at around 2.5, so nominal yields are much lower than even the conservative expectations from the TIPS markets.

[00:24:08]

That means that real yields are negative, and we know that if you buy bonds and you hold them to maturity, the return you earn on those bonds is basically the yield that you're getting upfront. If you're buying 10-year Treasuries and you're holding them to maturity, which you would not be doing if you own a bond fund because the portfolio managers are going to be buying and selling, but if you were just to buy a bond and hold to maturity and you're getting a 1.5% yield, that is your nominal return. Right now, if you were to lock that in, if inflation, even if it's just at 3 for the next 10 years, you would lock in a negative real return. So the 40 side is a real conundrum right now for a lot of investors. That's why we go to the TIPS market, but this is also why we go to Bitcoin and gold as real stores of value. Others as well: real estate, even high-yield corporate bonds which tend to have a lower duration. There are a number of ways to slice and dice that 40 but to me, this is where crypto really steps in. It's more on the 40 side than the 60 side.

[00:25:23]

Pamela Ritchie: [Audio cuts out] thoughts on parts of the world, looking at EM, for instance, which is largely a discussion about China because it makes up such a big part of EM. In fact, just some breaking news, you probably saw it on your Bloomberg too, but the U.S. and China are making a joint statement out of COP24. They're coming together with a joint statement of some sort. That said, there's a lot of moving parts with obviously what's gone on in the Chinese equity markets over the last three to four months due to policy. How do you view EM generally?

[00:25:56]

Jurrien Timmer: EM, it's been everyone's favourite overweight for many years and for many years that was the correct thing to do. The demographics are much better, real rates are much higher, so there are a lot of good reasons to want to be in emerging markets. Certainly the valuation discount to the U.S. is very compelling as well. Structurally, I like emerging markets. I think the dollar, it's been holding up quite well over the last year or so even though the Fed has been pursuing an extremely inflationary policy. Over the long term, I totally see and agree with having exposure to emerging markets a) as a play on a weaker dollar, b) as a play on getting real returns, real yields, better demographics, lower valuations. There's a whole list of reasons to be in that space. The one unfortunate part is, and China looms large here, is that (actually we can go to slide 25 to highlight this) is that ultimately the relative performance of one country versus another or one region versus another, EM versus U.S., comes down to really one thing and that is relative earnings. This is a very busy chart. I'm not going to explain the whole thing but if you look at the bottom panel, those black squiggles is the progression of earnings estimates for each calendar year going back to the 1990s and measured as EM earnings estimates minus the U.S. earnings estimates. It shows you the relative momentum of earnings revisions of EM versus the U.S.

[00:27:52]

You look at the yellow bars overlaying those squiggles, that is the relative return of EM versus us. It doesn't take a chartist to see that those two things are highly, highly correlated. To me, to get the relative performance right, you need to get the relative earnings right. We know that China is a big chunk of EM and China is slowing. We know all the headlines that have been playing out over the past 6 to 12 months with the Chinese government reining in its economy. That is a drag on EM and it's a drag on EM earnings. You can see, if you go all the way to the right-hand side of that chart, you see that the squiggle for 2021 and for 2022 are both losing ground to the U.S. We need the relative earnings momentum to turn around before, in my view, EM starts to outperform the U.S. as a block. Individual companies, obviously totally different story. This is one reason why I always advocate for active management when you go into the EM markets. As a block, we need to see those little squiggles turn positive before I start to get comfortable or start to have conviction that EM is finally going to outperform.

[0029:21]

Pamela Ritchie: Fabulous charts and analysis. Jurrien Timmer, thank you very much for joining us, appreciate your time and we'll see you again soon. Thank you.

[00:29:29]

Jurrien Timmer: Thank you, Pamela.

[00:29:32]

Pamela Ritchie: [Audio cuts out] today on Fidelity Compass. Thank you for tuning in today. If you have suggestions for future topics or guests that you'd like to see here on the show, please let us know. In the meantime, do stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Pamela Ritchie.