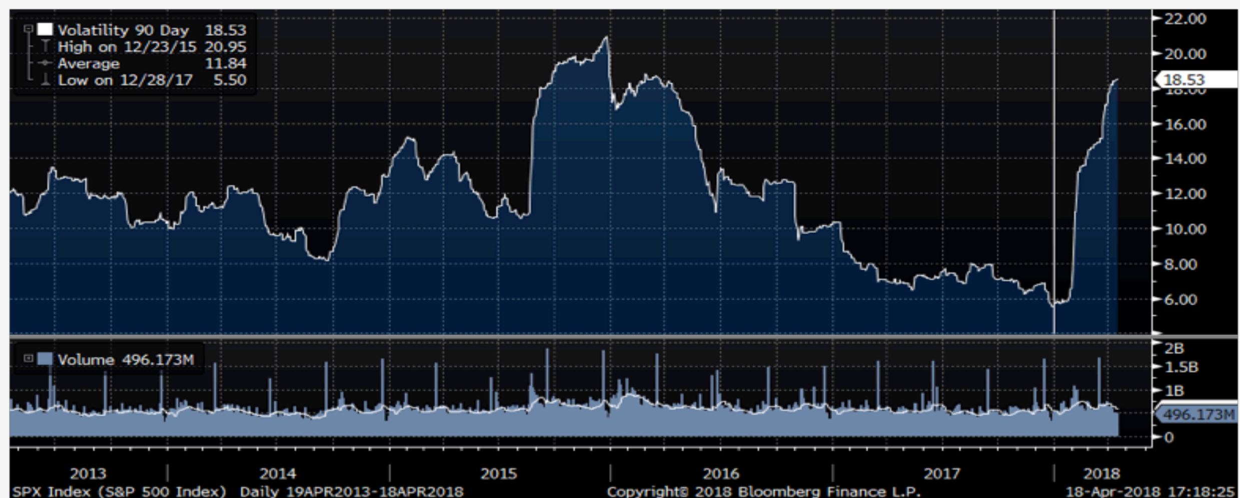
Narrative Risk

By Richard Thies

One of the rewarding things about putting your thoughts about economics and markets out there for the world to read on a regular basis is that in the rare scenario where you actually make an accurate prediction, you can point to it as evidence of your competence and ignore the other countless things you have been wrong about. In our year-ahead outlook for 2018, The Volatility You Can See Coming, we argued that the salient feature for this year would be an increase in market volatility. We are far from doomsayers but the combination of record low realized volatility and increasingly volatile economic readings led us to the simple conclusion that realized volatility was going to pick up.

With the first quarter in the books and realized volatility up threefold during the quarter (Exhibit 1), both for reasons we expected and also from tweets we could not have forecasted, we see our central thesis continuing to play out as the year continues. The primary component of our thesis is that the increasingly cyclical nature of the global economy toward the end of last year would create more volatility in readings and thus markets. We see the first test of the economy's increased cyclicality coming soon and also believe the popular narrative of 'synchronized global growth' as being potentially at risk as leading economic indicators are now clearly pointing down. The extent of the economic slowdown that ultimately manifests and how the markets react to it are the primary questions facing markets, both for how it affects market levels and relative asset price performances as well as its impact on the US dollar. We see this situation being related to another ongoing dynamic which is the increasing preference for assets that are inflation-beneficiaries over previous winners in price-taking industries. On a short-term basis we see the prevailing narrative of stronger global growth being at risk, while on a long-term basis we see the dominant narrative of perpetual goods-price deflation being similarly precarious.

EXHIBIT 1:
Realized volatility in the U.S. spiked during the first quarter



Source: Bloomberg

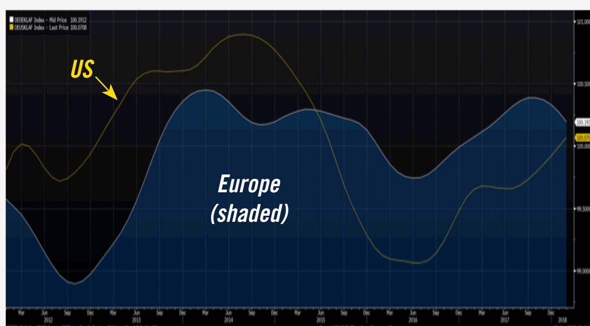
When the data go slow, The Fed still goes high

The prevailing narrative in global markets continues to be one of 'synchronized global growth' going forward and there's good reason for this. Namely, that there has already been stronger, synchronized growth for the past 24 months. Simply extrapolating the dominant cyclical trend from the past two years into the future isn't the wisest decision in our view, but this remains the most common description of the global economy that we see. We would describe the global economy as being in a mostly-synchronized slowdown, with the US bucking that trend and being the only major economy showing improved performance of late. (Exhibit 2) There are a number of reasons why it's important if this market consensus is wrong, but we focus on two major ones after first checking in with the data.

The global economy has been in a good place for the last two years. The absence of any major crisis (European sovereign, China hard-landing, etc) combined with a sustained period of US dollar weakness has led to an extended period of easier financial conditions. While easy financial conditions are a necessary condition to improving global growth, they aren't sufficient. The incremental push to global growth came from Chinese stimulus in 2016, which flowed through very quickly to European data and the rest of the world. Domestic financial conditions in Europe have been extremely loose the past two years and credit supply very available, which when combined with a manufacturing growth push aided by Chinese demand made things look pretty attractive. This trend was boosted by broad improvements in emerging markets (where most of the beta in global cycles still comes from) on the back of stronger currencies, lower rates and improved developed market (DM) and Chinese demand. Many of these factors remain supportive, especially that the emerging market (EM)-complex excluding China remains on a broadly improving growth path. One thing that has changed is that leading indicators in China have become even more negative in the past quarter as monetary conditions have tightened considerably. This has an explicit link to global, and especially European growth. (Exhibit 3)

First, since the financial crisis, each material downturn in global leading indicators has led to a period of risk-off, poor market returns and a rally in long-duration interest rates. Since this slowdown started appearing in the data, we have had some heightened volatility but markets are broadly flat and interest rates have risen in the long end in most markets. We see two explanations for this different reaction function. The first is that the Fed is in the midst of a primarily supply-side driven tightening cycle and the weaker global growth outlook doesn't change much and until it does, the natural pressure remains up across different tenors of interest rates. The second is that the market is of the belief that while growth is slowing, it is from a high level and the level where things trough will be higher than recent cycles, so it isn't too worrisome. We are admittedly uncertain about whether this is accurate or not and see compelling arguments on both sides, but we do have certainty that the market is priced for this downturn to be very mild and short-lived. Given that this slowdown in global data will be accompanied by a resolutely tightening Federal Reserve for the first time, we're on the more cautious side of this argument.

EXHIBIT 2:
The behavior of U.S. and European leading indicators do not suggest an environment of synchronized global growth of late



Source: Bloomberg

EXHIBIT 3:
Improved Chinese demand led the recovery in German manufacturing and is now set to decelerate further

Source: Bloomberg

The Rebirth of Divergence

The second major implication of this slowdown is how disparately it looks to be affecting the global economy. In our view, the primary reason this matters is the impact on currencies, specifically the US dollar. As long-time readers of ours know, we place extremely high importance on our dollar view given both how it affects relative asset prices and how it affects the global economy (a weaker dollar is a tailwind, a stronger dollar a headwind, almost always). The dollar has behaved a bit strangely in the past few months. The key relationship driving it used to be rate differentials with other developed markets, so higher US rates relative to the rest of the world meant a higher dollar (Exhibit 4). This has not been the case as of late and we're not surprised by that. The dollar tends to weaken when the global economy is growing and outpacing the US and almost every currency weakens when fiscal deficits and current account deficits are widening, which has been a salient feature of the new tax legislation. As discussed, we see the first of these conditions changing and wonder whether the large dollar discount that appeared as a result of the new fiscal realities in the US has been met. Going forward, we expect the near-term news on the US fiscal accounts to be more restrictive as Congress takes on entitlements. If both these factors change, and real rate differentials strongly support the greenback, there could be a meaningful tactical rally in the dollar, which would create greater downside risk to markets exacerbated by heavy positioning in weak-dollar trades. (Exhibit 5)

EXHIBIT 4:
The difference between expectations for short-term ECB tightening and the Fed suggests a Euro closer to 1.15 but U.S. fiscal concerns have left the dollar weaker (white- ECB-Fed tightening expectations, yellow- Euro)

Source: Bloomberg

EXHIBIT 5:
Long Euro speculative positioning is at record extremes

Source: Bloomberg

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Inflation Rotation

The increase in inflation in the US has received a lot of attention recently as core inflation has gone from 1.7% to 2.1% over the past nine months, much of which has been from higher commodity prices and base effects. In any event, it seems odd for the market to be preoccupied with inflation when core inflation is hovering 10 basis points above the Fed's target and currently losing some momentum, but we agree that it bears monitoring. We are less concerned with inflation skyrocketing or the Fed being behind the curve as we see that requiring a combination of sharply improved domestic demand conditions, stronger monetary growth and services price pressures that we just don't see changing that quickly.

However, we are concerned because we think an important inflection point in the global economy has passed and that is the steady period of persistent goods deflation. We have already seen this inflection point in the data and we expect it to accelerate going forward. If there is one thread of logic to this administration's policies it is that everything they're doing is inflationary; major fiscal stimulus, increasing of trade barriers, reducing crucial labor supply through less immigration, etc. We don't believe that's a coincidence either. We had the opportunity to meet Steve Bannon following his dismissal from the White House last fall and he agreed with us that this policy mix would increase inflation but believed it was a very small price to pay to reorient the US economy back inward and more toward benefiting domestic labor.

All of these policies are supports to prices, though not in scale to cause a broad spike to the consumer price index (CPI) given the relatively smaller impact of goods prices in headline inflation rates. Despite that, we see the market undergoing a subtle shift where goods-producing businesses are starting to be rewarded at the expense of price-taking, deflation-beneficiary companies. In addition to the policies described above, we see global investment in goods-producing businesses as having been very low the past five years, with supply having come out of the market in many materials industries especially. This has been the reality in industrial commodity markets, in commodity tech products like semiconductors, and we now are seeing the same to an extent in energy markets. Consumer discretionary and internet companies have been primary beneficiaries of deflation and unsurprisingly, have been the largest exposures for many investors. We see the latter sector being increasingly exposed to regulatory pressures, which has increasingly come to the fore. We do not think you need to believe the major internet companies become public utilities to be concerned that the incremental regulations are going to be negative, compliance costs will spike, and monetization more challenging going forward. Further, we see that many of the large companies in the tech sector have started to fuel their growth while increasingly burning free cash flow and relying on borrowings. This is hardly a new phenomenon and it's no surprise that volatility in this sector tends to rise relative to the broader market at periods when short-term funding rates are increasing; we're surprised this hasn't received more attention yet. (Exhibit 6)

EXHIBIT 6:
Volatility of the tech sector relative to the broader market increases as short-term interest rates rise (White- Nasdaq VIX over S&P VIX, Green- US 2yr swap rates)

Source: Bloomberg

Given our focus on second-derivative changes to the earnings growth outlook, we think this is very important. We leave you with one chart to ponder these dynamics as we continue down the increasingly volatile 2018: the historical relative performance of the energy sector compared to the tech sector. (Exhibit 7)

EXHIBIT 7:
The energy sector's performance versus the tech sector has come full circle over the past 20 years

Source: Bloomberg

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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