BondAdviser

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Fixed Income Research

Inflation Strategy

What Goes Down Must Come Up

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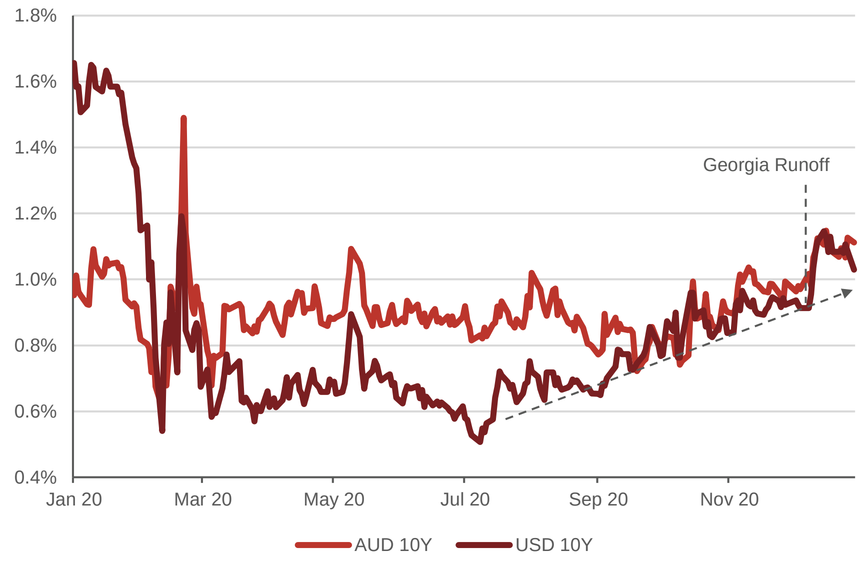
The tandem strength of fiscal and monetary stimulus alongside a widespread vaccine rollout underlines our view that the economy will rebound quicker than expectations.

Vaccine optimism has driven a steady rise in government yields since September. The results of the Georgia runoff election, determining the majority of the US senate, has resulted in a clean sweep to the Democratic Party. This spurred expectation of further government spending, causing a 20bps surge on the US 10-year, pushing yields above 1% for the first time since the pandemic.

Figure 1. AUD / USD 10 Year Yields

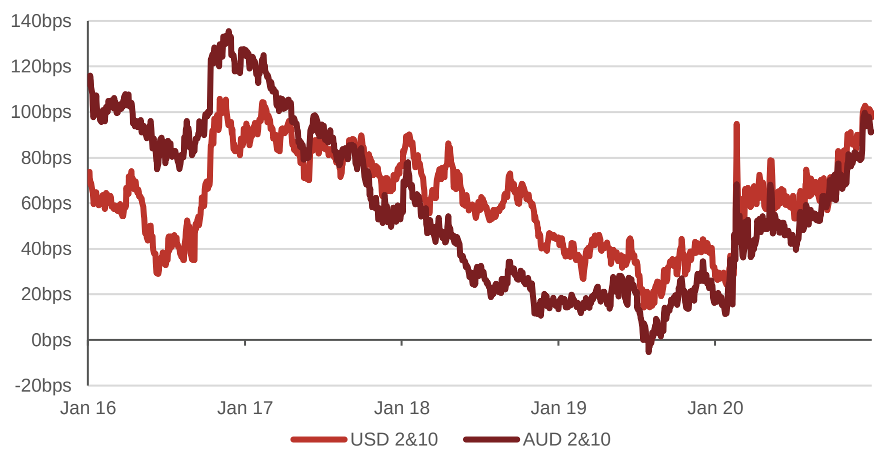


Source: BondAdviser, Bloomberg. As at 28 January 2021.

A more descriptive picture is the steepening of the yield curve. This is typical of a reflation trade. Fiscal activism in the form of infrastructure, wage subsidies or cheques, makes a positive difference to economic growth, given in most developed economies, consumer spending drives the majority of GDP[1]. A continuation of support here is different to the post-GFC environment where sovereign debt serviceability was front of mind. In contrast imagine of how unpalatable fiscal conservatism would be in the current environment - i.e. think of austerity measures (and riots) in Ireland, Greece and Spain in 2011.

[1] Average of 56.8% of Australian nominal GDP between 1959-2020. US equivalent average of 63.2% between 1947-2020. Per CEIC data.

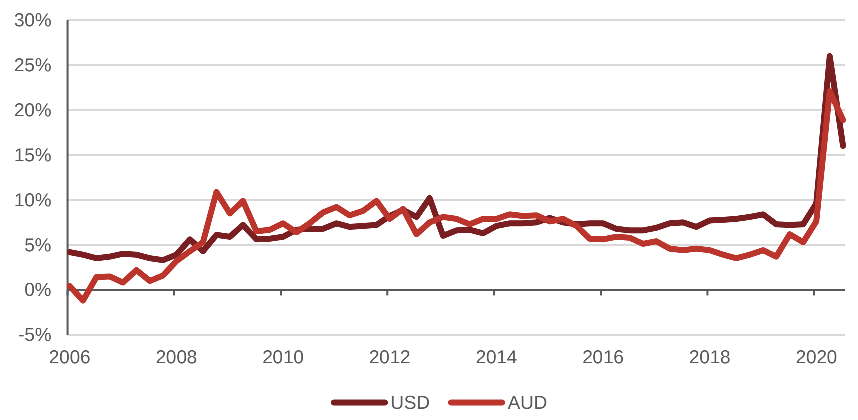
Figure 2. AUD / USD Sell 2 Year & Buy 10 Year Yield Spread



Source: BondAdviser, Bloomberg. As at 28 January 2021.

Continued coordination between Treasury and the Fed in the US and/or the Government and RBA in Australia will stimulate the economy and push bond yields up. Notably, there is a difference between healthy reflation and surging inflation. Currently, markets have priced in the former. There are inflation pressures present and these may continue as the economy improves, notwithstanding a devastating breakout of a new strain. At this stage, higher inflation expectations appear like a one-way road, however the speed travelled along this road remains contentious.

Figure 3. AUD / USD Personal Savings Rate



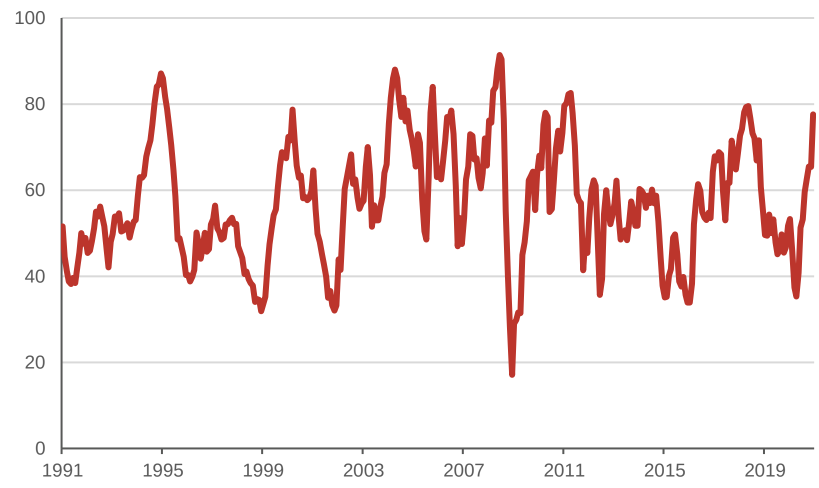
Source: BondAdviser, ABS, Bureau of Economic Analysis. As at 28 January 2021.

In terms of pent-up demand, savings rates in both Australia and the US are historically high. Our cautiousness regarding a quicker-than-expected increase in inflation largely stems from this being spent into 2H21, especially if: (1) locally we see an improvement in the labour market (and associated wage pressures): and (2) the pandemic normalises more quickly in developed economies.

Other cost pressures can be seen in rising soft commodity and oil prices[2]. The particularly strong Manufacturing ISM numbers in the US signal the core of the economy is heating up again. ISM prices typically are a good leading indicator to producer price inflation. This form of cost-pull inflation could be particularly unexpected and violent, but something we have been mindful of since May.

[2] ICE BofA Soft Commodity Index up 46% since April. Brent crude oil is up 192% since April.

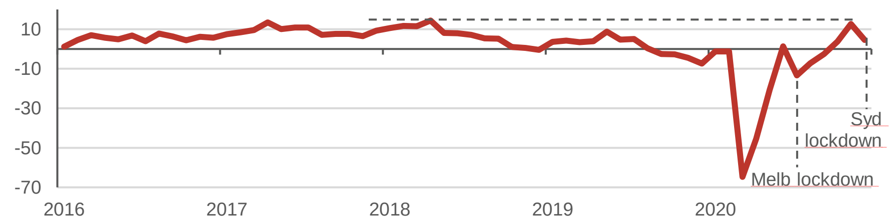
Figure 4. US ISM Manufacturing - Business Prices (Not Seasonally Adjusted)



Source: BondAdviser, Bloomberg. As at 28 January 2021.

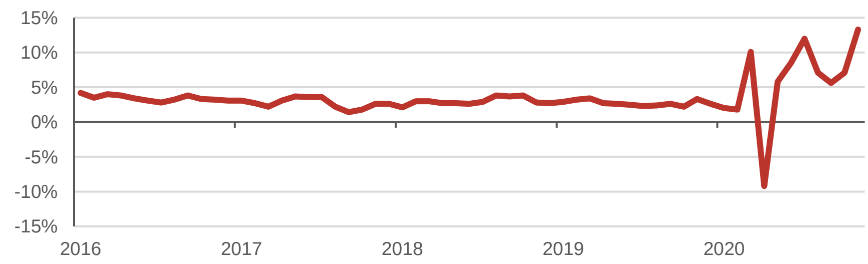
Locally, we have seen a surge in business confidence and retail sales, as seen in Figures 5 and 6. This adds support to the expectation that the domestic economy will improve quicker than the RBA forecast.

Figure 5. NAB Business Confidence Index



Source: BondAdviser, NAB. As at 28 January 2021.

Figure 6. AUD Retail Sales (Year-On-Year, Seasonally Adjusted)



Source: BondAdviser, ABS. As at 28 January 2021.

An unemployment rate of ~5.5% in Australia by year's end CY21 is bullish with respect to street expectations (noting that unemployment in February 2020 was 5.1%), but should this manifest, wage pressures may also unexpectedly add to core inflation – the key measure tracked by the RBA.

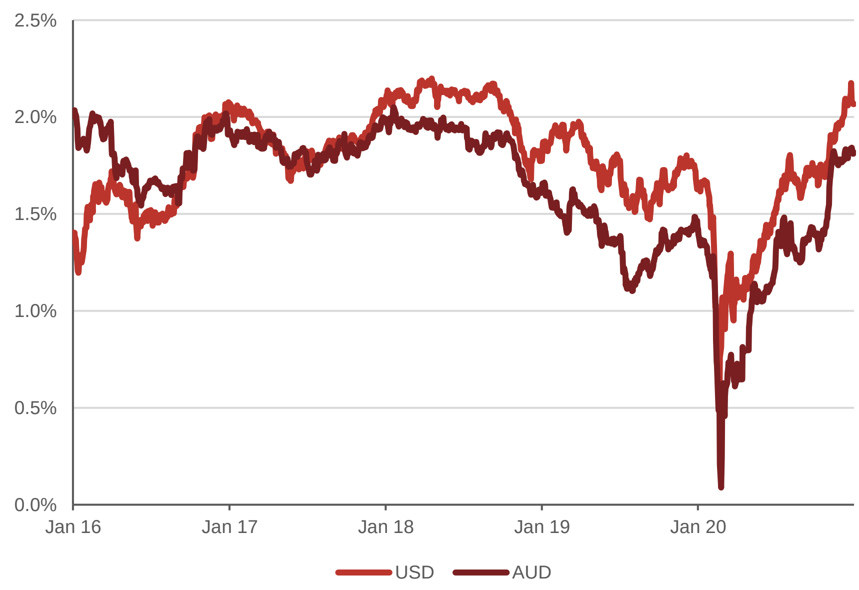
Figure 7. Consensus Expectations on Domestic Economic Indicators

		Q4 20	Q1 21	Q2 21	Q3 21	Q4 21	Q1 22	Q2 22
Real GDP	High	-1.30	0.30	9.10	8.10	9.10	5.00	4.40
	Average	-2.50	-1.10	7.60	5.20	4.00	3.70	3.60
	Low	-5.40	-3.60	-2.00	3.10	2.70	2.70	2.50
CPI	High	1.20	1.20	3.20	2.10	2.60	1.90	2.20
	Average	0.90	0.50	2.70	1.50	1.50	1.50	1.60
	Low	-0.70	-0.40	1.40	0.60	0.50	0.60	0.80
Unemployment	High	7.70	7.60	7.50	7.20	7.00	6.80	6.60
	Average	6.80	7.20	7.10	6.80	6.50	6.20	6.10
	Low	6.80	6.40	6.20	6.00	5.70	5.50	5.60
Cash Rate	High		0.10	0.10	0.10	0.10	0.10	0.10
	Average	0.10	0.10	0.10	0.10	0.10	0.10	0.10
	Low		0.10	0.10	0.10	0.10	0.10	0.10
Treasury 10Y	High		1.10	1.50	1.80	1.90	1.90	1.90
	Average	0.97	0.90	0.96	1.03	1.09	1.12	1.17
	Low		0.60	0.60	0.60	0.55	0.55	0.55

Source: BondAdviser, Bloomberg. As at 28 January 2021.

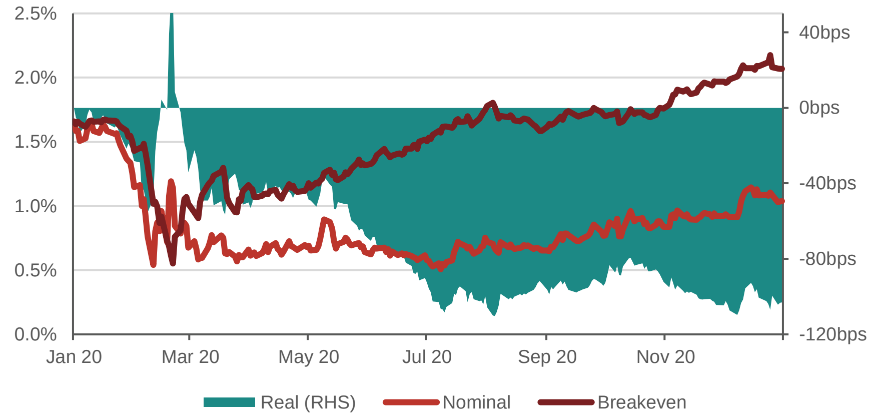
The tack in data has been noticed by markets, with the 10-year breakeven rate surging towards 2% through the second half of 2020. Put differently, traders now see domestic and US inflation averaging ~2% over the coming decade. The impact of rising breakeven has led to a further deterioration in real yields as central bank buying continues to distort the yield curve.

Figure 8. AUD / USD 10 Year Breakeven Rates



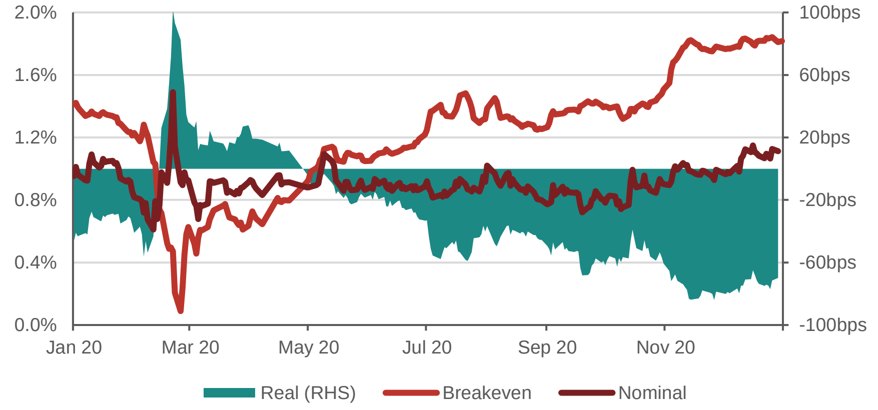
Source: BondAdviser, Bloomberg. As at 28 January 2021.

Figure 9. USD 10 Year Real Yields



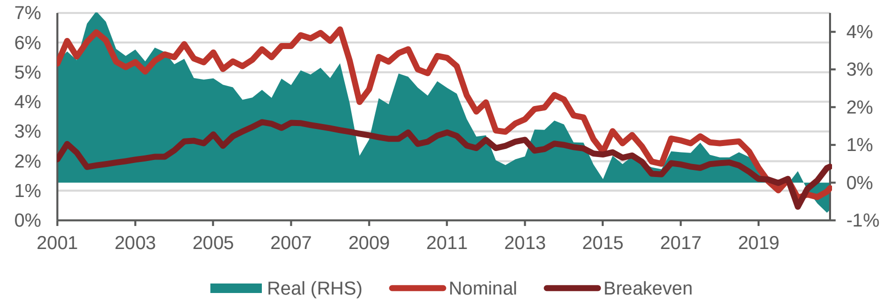
Source: BondAdviser, Bloomberg. As at 28 January 2021.

Figure 10. AUD 10 Year Real Yields (Short Term)



Source: BondAdviser, Bloomberg. As at 28 January 2021.

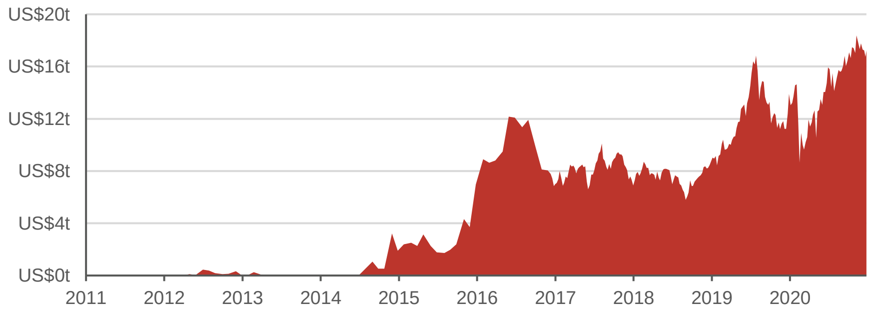
Figure 11. AUD 10 Year Real Yields (Long Term)



Source: BondAdviser, Bloomberg. As at 28 January 2021.

Notably, the amount of outstanding negative yielding debt remains elevated. So, whilst there has been some inflation repricing, it has not been at a systematic level by any means. Continued inflationary pressures, particularly at a structural level, could cause many headaches across asset classes. This is a key reason why we currently preference floating rate assets, either in loans or bonds, given the *de-minimis* duration exposure.

Figure 12. Global Negative Yielding Debt

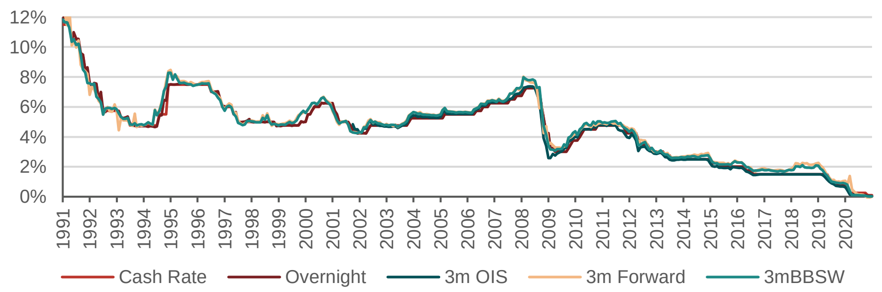


Source: BondAdviser, Bloomberg. As at 28 January 2021.

In Australia, central bank support has come in several forms. Base rates have never been lower, the RBA is de-facto financing nearly *all* of the Australian Government's deficit for 2020-21. More underhandedly, the Term Funding Facility has acted as an implicit bailout for deposit taking institutions.

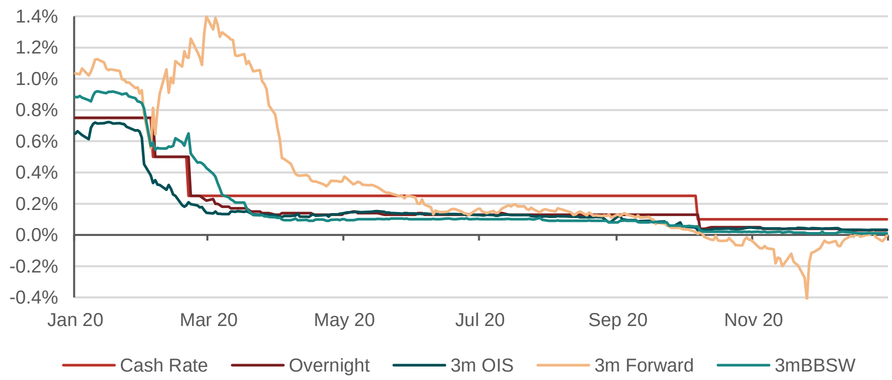
As demonstrated in Figure 14, there was evidence that money market stress was present in March. Support from regulators ensured that a health crisis did not turn into a solvency or liquidity crisis. This is good policy. The downside is that now money markets are flooded with liquidity. We expect this thematic will continue to anchor short term rates.

Figure 13. AUD Money Markets (Long Term)



Source: BondAdviser, Bloomberg. As at 28 January 2021.

Figure 14. AUD Money Markets (Short Term)



Source: BondAdviser, Bloomberg. As at 28 January 2021.

Cheap money is well known as a required factor for an asset bubble to form. Although domestic valuations look frothy already, should money remain artificially cheap, the RBA risks distilling a tail-risk problem.

Meanwhile, cheap credit also has implications for inflation. Housing prices and development have been remarkably resilient. With continued low rates, further inflationary pressures may catalyse from here - as was evident in the most recent data tape.

Market consensus is that inflation will return, but with a whimper not a bang. In any effect talk of rising yields now seems to be in vogue. Without a vaccine failure, new variant or asset bubble burst, we see there to be little reason for rates to fall further. With the street pricing in a slow increase in yields, we think the data is more suggestive of a more aggressive overshoot and then normalisation of inflation. Assuming rates do not fall, which seems unlikely, the general positioning advice remains unchanged – again, it is a one-way road in reducing duration, increasing FRN's and ILBs.

Inflation can be treated as a dirty word in some circles and the thought of a rate raise is currently sacrosanct for many talking heads. We view the rates front as being quiet in CY21 but firmly in play for CY22-23 given the fiscal and monetary adrenaline shock injected into markets.

A further adjustment upwards in rates would be painful for housing and asset prices more generally. But ultimately, this would be a traditional signal (which might even be healthy) that the economy requires a gradual brake as it returns to functioning under its own steam.

Whilst the idiom "what comes up must come down" stands to reason through gravity, in markets and economies, what goes down must come up by a function of normalisation and mean reversion. Whilst we are not bullish on the size of recovery, we are on the speed due to artificial support. In other words, we expect normalisation to occur more quickly than expected and to avoid bearing this impact upon re-pricing, we favour reducing duration exposure. We have held this view since May and will likely continue to do so until we have seen a reversion in growth, unemployment and inflation data.

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