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The View from 1167 | Reflation, Stagflation, or Disinflation?

The reflation trade is back!

The last few weeks have witnessed a sharp sell-off in core DM government bond markets. From just over 1.0% at the end of January, the yield on the 10 year US Treasury briefly broke 1.6% on February 25. Other DM markets followed suit. On this side of the pond, the 10 year UK gilt jumped from 0.3% to 0.8% and the German bund from -0.5% to -0.2%. Even the 10 year Japanese Government Bond – supposedly fully anaesthetised by the BOJ's Yield Curve Control (YCC) policy – rose from 0.0% to 0.2%.

No doubt some older readers will be raising an eyebrow at the still extremely low numbers just quoted – and wondering what all the fuss is about. Others will remember the noise about the US Treasury 'Reflation Trade' which accompanied the election of Donald Trump in Q4 2016, and how it turned from Trump Bump to Trump Slump in 2019-20. But anyone who lived through the Taper Tantrum of 2013 knows only too well that a sell-off in the core DM government bond markets, if it is both large and rapid, can cause problems for risk assets.

It is not surprising that many investors are therefore asking two key questions:

1. Is this new reflation trade a problem for risk assets in general? and
2. How vulnerable are EM local currency government bond markets in particular?

In this note, I outline how we see the answers to these questions.

1. Is this new reflation trade a problem for risk assets?

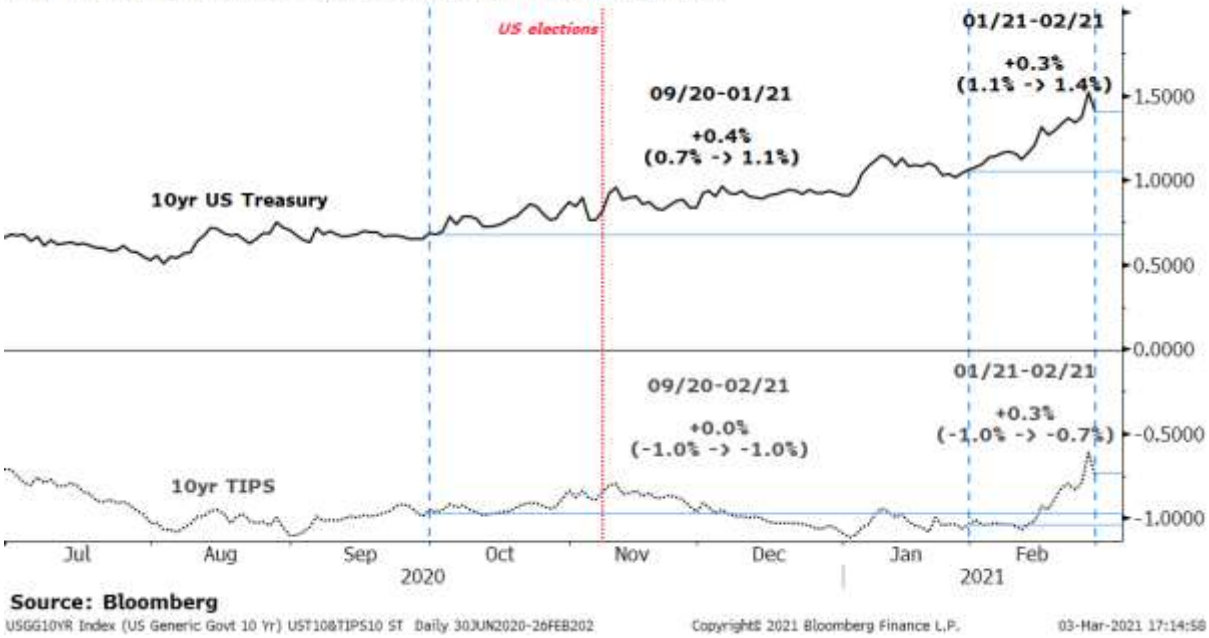
We always begin our global analysis by trying to read what the single most important financial market in the world – the market for US Treasury notes and US TIPS (Treasury Inflation-Protected Securities) – is telling us.

Figure 1 below shows the evolution of the Yield to Maturity on 10 year US Treasury notes and 10 year US TIPS from Q3 2020 until the end of February 2021.

The solid black line shows clearly the rise in the US Treasury yield that has spooked investors: a doubling from 0.7% at the end of Q3 2020 to 1.4% at the end of February. Figure 1 then breaks this move down between two periods – from the end of Q3 2020 until the end of January 2021; and from the end of January 2021 until the end of February, 2021 – demarcated by the blue dashed vertical lines. This breakdown shows how the +0.7% increase in the 10 year nominal US Treasury note yield was split fairly evenly between the two sub-periods. In the first, the 10 year yield rose by +0.4%, from 0.7% to 1.1%. In the second, much shorter period, it rose by +0.3%, from 1.1% to 1.4%.

The grey dotted line in Figure 1 tracks the 10 year TIPS yield – that is, of the equivalent *real, inflation-adjusted* yield on US government bonds. This real yield has behaved a bit differently. In the first period, the 10 year TIPS yield was roughly unchanged at -1.0%. In the second, it rose by +0.3% - the same amount as the 10 year nominal yield over that period – from -1.0% to -0.7%.

Figure 1: US Nominal and TIPS 10 year interest rate
Yield to Maturity on generic 10yr US Treasury note and 10yr TIPS



What's useful about a chart, like Figure 1, which shows nominal and real yields together, is that we can use it to infer what is actually driving shifts in the US Treasury curve. The difference between the *nominal* yield on a US Treasury note and the *real* yield on an equivalent maturity TIPS indicates the annual *inflation* that investors expect over that period.[1] So if US Treasury yields move higher, but TIPS yields do not, we can infer that the market is signalling an expectation of higher inflation – but not higher real returns. If, on the other hand, a shift higher in US Treasury yields is matched one-for-one by TIPS moving higher as well – that implies that it is rising real interest rates, not just rising inflation expectations, which are driving the action in nominal yields.

So what does Figure 1 tell us? In the first period, the increase in the *nominal* yield on the 10 year US Treasury note by +0.4%, while the *real* yield on the 10 year TIPS was flat at -1.0%, implies that *all* of the increase in the nominal US Treasury yield was driven by investors' increased expectations of inflation over the next decade: they rose from 1.7% p.a. (the difference between 0.7% and -1.0%) to 2.1% p.a. (the difference between 1.1% and -1.0%).

In the second period, however – from end-January to end-February – the pattern was different. The *nominal* 10 year US Treasury yield continued its ascent – rising +0.3%, from 1.1% to 1.4%. But this time, the *real* 10 year TIPS yield also rose – and also by +0.3%, from -1.0% to -0.7%. In this second period, in other words, investors' expectations of inflation over the next 10 years remained constant at 2.1% p.a. All of the rapid +0.3% increase in the nominal US 10 year yield represented an increase in the real US risk-free rate.

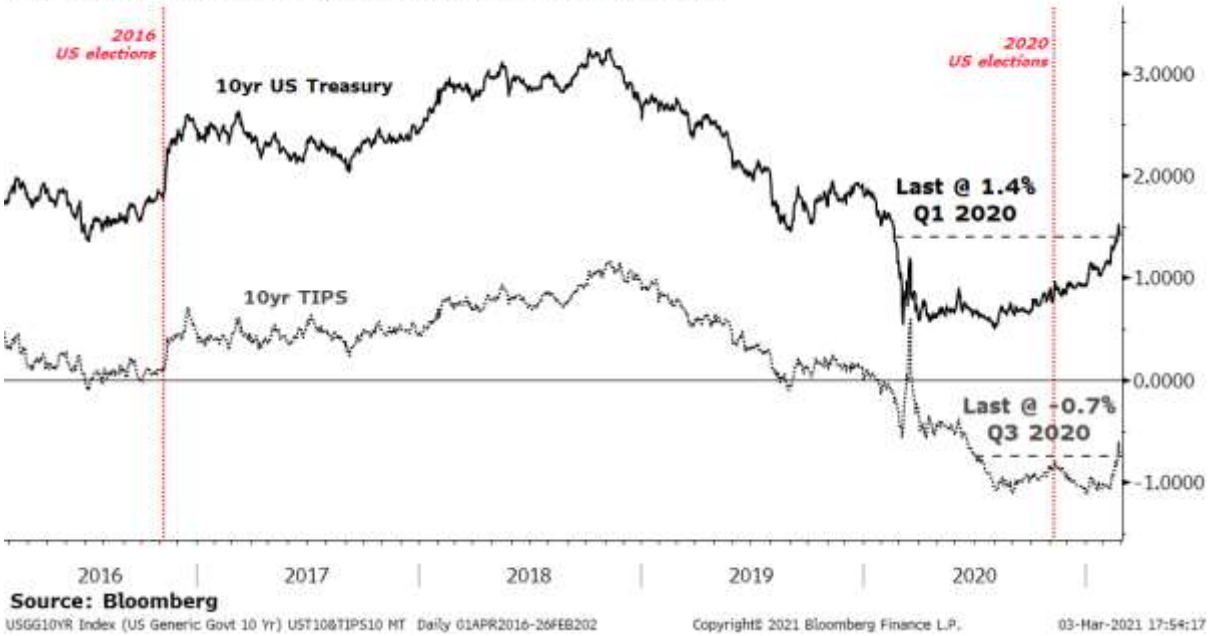
[1] This difference is often referred to, alternatively, as 'break-even' inflation – because it is the level of annual inflation which would equalise an investor's nominal returns if she held either nominal US Treasuries or TIPS of identical tenor to maturity.

There are four points worth taking away from this very simple analysis:

(i) Core DM real yields matter for global asset valuations, so investors are right to take notice. Things have moved on from when we delivered our Q1 2021 Quarterly Update in January. Back then, the relative movements of yields on US Treasuries and TIPS implied that the leak up in core DM bond yields was being driven by increased inflation expectations alone – not underlying real yields, which remained pinned close to all-time low negative levels. In February, however, it is real yields that have done the heavy lifting. When real yields move higher, the risk-free hurdle rate with which all risk assets compete rises: so it is time to check whether valuations are still justifiable.

(ii) But core DM real yields remain negative across the board. It is important to keep sight of the medium term picture, however. Figure 2 shows the same series as Figure 1; but going back to before the 2016 US Presidential election. With this perspective, two things stand out. First, nominal yields have unwound much more than real yields have: the last time the 10 year US Treasury yield was at 1.4% was almost exactly a year ago, at end-February, 2020; whereas the 10 year TIPS yield has only reverted to where it was in July. Second, the actual level of real yields in particular are still *exceptionally* low by historical standards. The experience of Japan and Europe has perhaps made investors numb to negative government bond yields. Figure 2 serves as a reminder that for the US, however – by far the world's most dynamic DM economy – it's the slump in real yields from positive to negative territory between 2018 and 2020 that is the big story, even after February's small spike.

Figure 2: US Nominal and TIPS 10 year interest rate
Yield to Maturity on generic 10yr US Treasury note and 10yr TIPS



(iii) The current situation looks very different to the 2013 Taper Tantrum. Looking still further back, it is not surprising that some investors are asking whether the 2013 Taper Tantrum is a relevant comparison to February's real yield spike. Figure 3 therefore extends the chart in Figures 1 and 2 back to before the 2012 US elections.

Figure 3: US Nominal and TIPS 10 year interest rate
Yield to Maturity on generic 10yr US Treasury note and 10yr TIPS

Figure 3 shows clearly several key differences between the situation in 2103 and 2021:

- **The sell-off in the US Treasury market in 2013 was driven entirely (and more) by real yields.** The Taper Tantrum was most definitely about a rapid increase in underlying real yields – the increase in which in fact *outpaced* the rise in nominal yields, rising by 1.4 percentage points between April and August, 2013 , whilst nominal yields rose only by 1.1 percentage points (implying that inflation expectations actually *fell* by 0.3 percentage points).

- **The 2013 Taper Tantrum was sparked by Fed tightening.** The clue to the origins of the 2013 real yield move is of course in its name. The Taper Tantrum was sparked by then-Fed Chairman Bernanke indicating (maybe inadvertently) that the US central bank was about to embark on its first re-tightening of monetary policy since the GFC by tapering its QE purchases. The contrast with 2021 could not be more stark. The Powell Fed has given no indication whatsoever that it is anywhere near tightening policy – and appears ready to do whatever it takes to accommodate US fiscal policy and stimulate employment and inflation with continued loose monetary policy.

- **The increase in real yields in 2013 was much larger.** Finally, the 2013 increase in real yields was obviously much larger than anything seen so far in 2021. The real 10 year US TIPS yield

jumped by 1.4 percentage points from negative (-0.7%) to positive (0.7%) territory. February's move of 0.3 percentage points, from -1.0% to -0.7%, is not in the same league.

Of course, any of the three differences above might change going forward. The 2021 sell-off might resume, driven by real yields. The Fed might suddenly reverse its policy stance and announce that it is tightening monetary policy. The 2021 increase in real yields might step up a gear and begin to match the 2013 magnitude. To decide how likely any of these changes are, it is therefore also important – maybe most important of all – to keep sight of the long term picture, and to:

(iv) Rule nothing out: *reflation*, *stagflation*, and *disinflation* all remain perfectly plausible futures. The real reason why investors are right to care about shifts in core DM nominal and real yields does not have to do with whether they moved +0.3% or -0.3% last month. It has to do with what the macro regime for the next two, five, or ten years is going to be. The February spike in US real yields may have been modest. They may remain negative. But is February's move the beginning of something bigger – maybe much bigger – that would call for significant portfolio reallocations? That is the perfectly reasonable question at the back of investors' minds.

It's worth considering at least three high level scenarios:

- It is not surprising that most of the journalism and analysis one reads at present is focused on the US shifting into a new, **reflationary** regime: the idea that the recent moves foreshadow both a *sustained real growth recovery*, and *higher inflation* in the US. This scenario would likely see both real and nominal yields marching higher – with nominal yields potentially *outpacing* real yields if the market loses confidence in the Fed's commitment or capacity to limit inflation to its 2% target.

- If the rise in real yields peters out, however, while nominal yields keep rising, that would instead signal that the US is moving into a **stagflationary** regime, with *growth struggling to reignite properly* after recovering its pandemic-induced dip, but *higher inflation* nonetheless. It isn't hard to see why this kind of scenario might materialise: indeed, it's easy to argue that both economic fundamentals (e.g. deteriorating demographics; scarring from the pandemic; etc.) and policy (e.g. the likelihood of continued financial repression in order to keep government borrowing costs low given the now astronomical levels of government debt) point in this direction.

- Then there is a third possibility: that at some point – perhaps because government and corporate balance sheets are so bombed out after the pandemic – any rise in yields generates a new economic slowdown. The result of that would presumably be that both nominal and real yields sink back to their 2020 lows – or maybe head even lower, to European and Japanese levels. This would be back to a **disinflationary** regime: *sustained low growth* and *low inflation* too.

Each of these three scenarios have their advocates in the analyst community. Each implies very different paths for future nominal and real yields. And each therefore has very different consequences for the discount rate on risk assets. The truth is, however, that no one knows yet which of these three scenarios (or some other one) is on the cards, if only because the Covid crisis is completely without

precedent. What I would caution, however, is that *all* of them are so far perfectly consistent with the moves in the US Treasury and TIPS markets year-to-date.

The one contribution I would volunteer is that with all the talk currently focused on *rising* US yields, the third scenario is probably the most heavily discounted at the moment. Yet Figures 2 and 3 above provide a cautionary reminder that hopes of a *reflationary* regime after the last US election in 2016 collapsed into the renewed reality of a *disinflationary* regime long before Covid came along.

How surprised would any of us really be if that eventually happened again?

2. How vulnerable are EM government bond markets?

The second question I'd like to consider is what each of the three scenarios discussed above would mean for EM government bond markets.

As discussed above, investors are right to take notice of the possibility of the **reflationary** scenario hinted at by February's spike in real yields. Other things being equal, if higher real yields are available on US government bonds, that is likely to put pressure on competing financial assets across the board by effectively raising the rate at which future cash flows should be discounted.

In this scenario, a key question for investors will therefore be which asset classes have a margin of safety embedded in their current valuations that might enable them to absorb some of pressure from more competitive risk-free rates on core DM government bonds.

It's easy to see why that question leaves investors in some asset classes a bit uncomfortable. As you have heard us observe on many occasions, quite a few asset classes have done very well over the past eight years largely as a result of capital gains generated by significant re-ratings of their historical valuation metrics – the steamier parts of the global equity markets, many credit asset classes globally, and real estate in some jurisdictions are all examples. An obvious question is therefore how close to exhaustion that engine is for those asset classes – and whether a revival of real yields on risk-free government bonds might cause them to reverse somewhat.

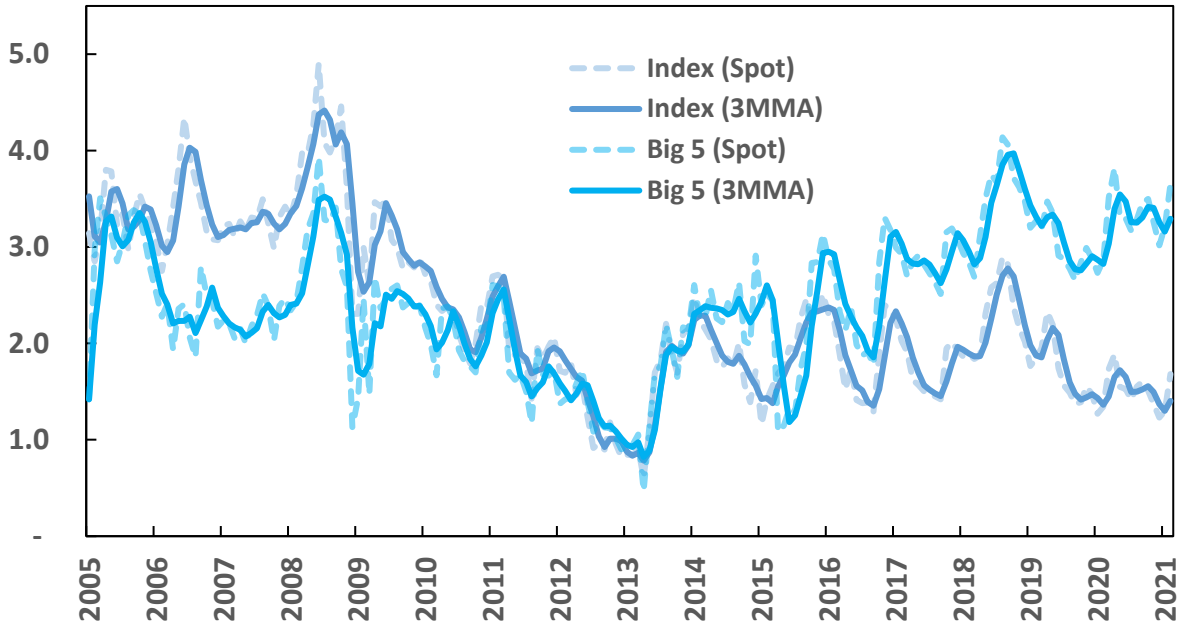
What about EM local currency government bond markets? How are the key valuation metrics for these markets – the prospective real yields available – faring? Is this an asset class which is looking expensive or cheap, on a historical basis?

Figure 4 provides one perspective on these questions. The chart shows prospective real yields calculated using the nominal yields available in the market adjusted for expected future inflation, using the IMF's most recent forecasts for year-ahead inflation at each point in time.[2] For the GBI-EM GD index as a whole (the dark blue lines) the current level of prospective real yields is, at 1.7% at the end of February, 2021, very close to the average of the last five years (1.8%).

[2] This is one of the main real yield metrics that we use in our investment process at 1167 Capital. The benefit of using nominal yields at market prices deflated by the latest IMF forecasts is that permits the construction of a metric that is (i) consistent across most countries in our investment universe and (ii) based upon inflation forecast from a respected and impartial source. Prospective real yields observed directly from inflation-linked government bond markets (which can often diverge from calculated real yields) – the equivalent of TIPS yields quoted above for the US – can also be used in the subset of EM bond markets where they are available.

Figure 4: EM LC Prospective Real Yield

JPM GBI-EM GD index / Big Five EM (Brazil, Mexico, Russia, SA, Indonesia; equal weights) index real yields, calculated using IMF WEO inflation forecasts



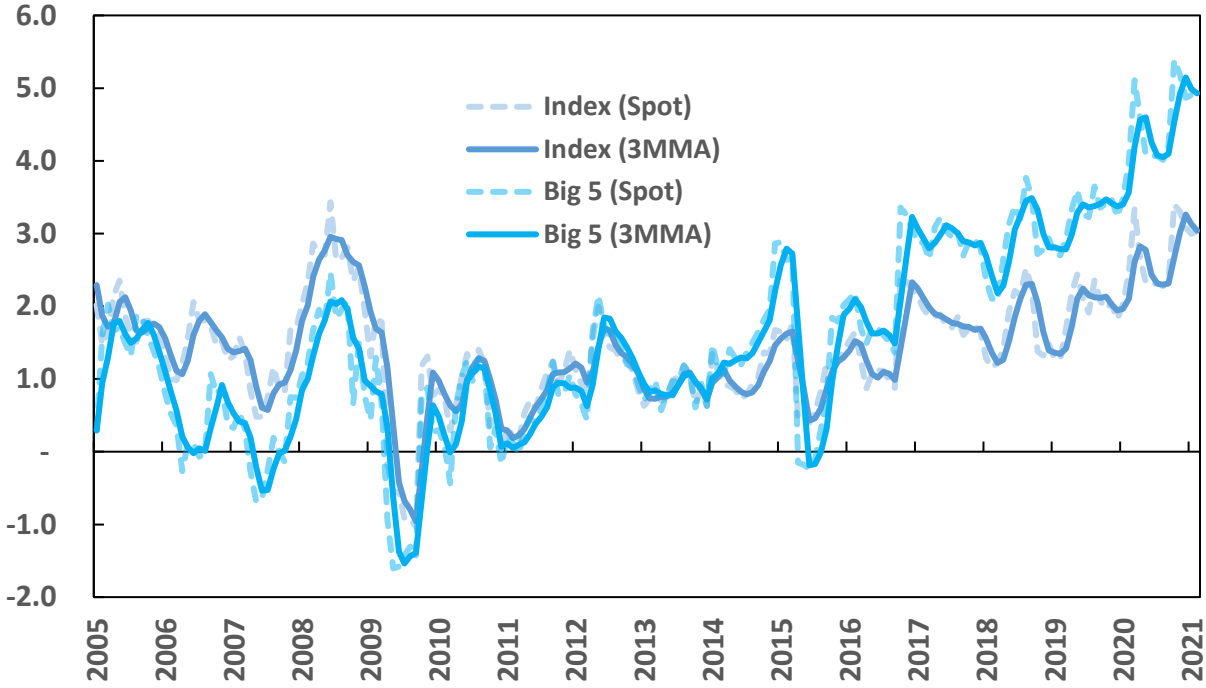
As ever, index-level statistics tend to be 'conservative', due to the periodic turnover of constituents. So Figure 4 therefore also shows the prospective real yields on another, more directly relevant index: an equally weighted basket of what we call the 'Big Five' EM local currency markets – Brazil, Mexico, Russia, South Africa, and Indonesia. The prospective real yield currently available on this index – 3.7% – is well above its five-year average of 3.0%, and indeed at historically quite an elevated level.

Absolute levels of prospective real yields such as those illustrated in Figure 4 are useful a useful gauge on their own. Since the global government bond universe available to investors spans both the DM and EM, however, the really relevant metric – and the one that is more closely equivalent, for example, to credit spreads in the hard currency credit space – is the *spread* between the prospective real yields available on EM local currency government bonds and, for example, US government bonds.

Figure 5 therefore shows how these prospective real yield *spreads versus the US* have evolved for the GBI-EM GD index and the Big Five EM respectively.

Figure 5: EM LC Prospective Real Yield Spread versus US

Spread between JPM GBI-EM GD index / Big Five EM (Brazil, Mexico, Russia, SA, Indonesia; equal weights) index and US 10 yr real yields, calculated using IMF WEO inflation forecasts



On this *relative* metric, the prospective real yields currently available on EM local currency government bonds, both at the overall index and at the Big Five basket levels, look even more compelling. As of end-February, 2021, the prospective real yield spread versus the US was 3.0% for the GBI-EM GD index (compared to a five year average of 1.9%). For the Big 5 EM basket, the spread stood at 5.0% - nearly two full percentage points higher than its 3.2% average over the last five years, and just off its highest level of the past decade and a half.

As with valuation metrics for any financial asset, Figures 4 and 5 should not be used to try to predict future returns with any precision – still less to time the market. But I think they do suggest that the margin of safety currently embedded in the spread between EM and US prospective real yields looks pretty generous – and especially for some of the larger and more liquid EM sovereigns.

Once again, a clear difference with the 2013 Taper Tantrum episode also emerges. Back then, these prospective real yield spreads were much smaller – less than 1.0% for both the index and for the Big Five EM basket: there simply wasn't nearly so much of a prospective real return premium on offer for lending to EM governments. Today, by contrast, the cushion is as wide as it has been for fifteen years.

There are provisos of course. The IMF's inflation forecasts may be off; the pace of any sell-off in core DM rates matters as well as the size; the size of the spread demanded by the market depends on global investor risk appetite as well as economic fundamentals; and so on. My observation is simply that even allowing for these uncertainties, Figures 4 and 5 suggest to us that both in absolute terms and even more so relative to what is on offer in DM, EM local currency bonds are by no means priced at extreme valuations. This is not one of the asset classes currently priced for perfection.

What about the other two scenarios for core DM real yields discussed above? Well, the **disinflationary** scenario, in which both real yields and inflation expectations moderate again – or even resume their declines – is easiest to think through. If it transpires that even the gigantic US fiscal stimulus currently under consideration manages only to backfill deficient private sector demand temporarily, so that the recovery is not self-sustaining, then EM local currency government bonds will probably have little to fear from core DM yields.

In this scenario, we would expect the historically wide prospective real yield spreads shown in Figure 5 not just to buffer against competition from DM bond markets, but to drive potential capital gains – via either or both of currency appreciation and rallying bond prices – as investors renew their search for positive real yields.

The **stagflationary** scenario is also well worth considering. As in the disinflationary scenario, core DM real yields would be contained in this scenario – so that the much higher prospective real yields available in EM could be expected to exert themselves.

The difference with the disinflationary scenario is that we might expect the balance of any capital gains that accrue to EM local currency government bonds to skew more in favour of currency appreciation – as higher US inflation, unsupported by improved productivity or real growth, simply feeds debasement of the US dollar.

Ultimately, our key conclusion from Figures 4 and 5 is simple. Regardless of which scenario materialises over the next few years in the core DMs, the level of prospective real yields in EM local currency government bond markets – and especially in some of the larger, more liquid names – seem to provide a reasonable margin of safety in the event that core DM real yields head back into positive territory; and room for a significant compression in spreads – implying corresponding strong returns – if, in the end, they don't.

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