Global Macro Strategy

Jefferies

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The Winners and Losers from the Great Reflation

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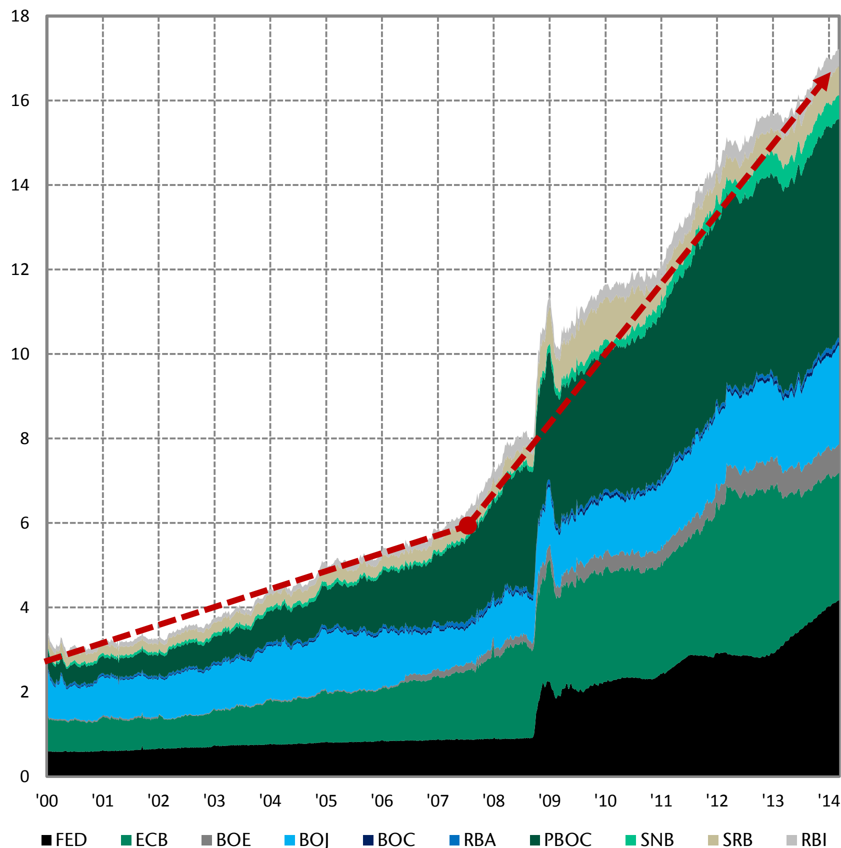
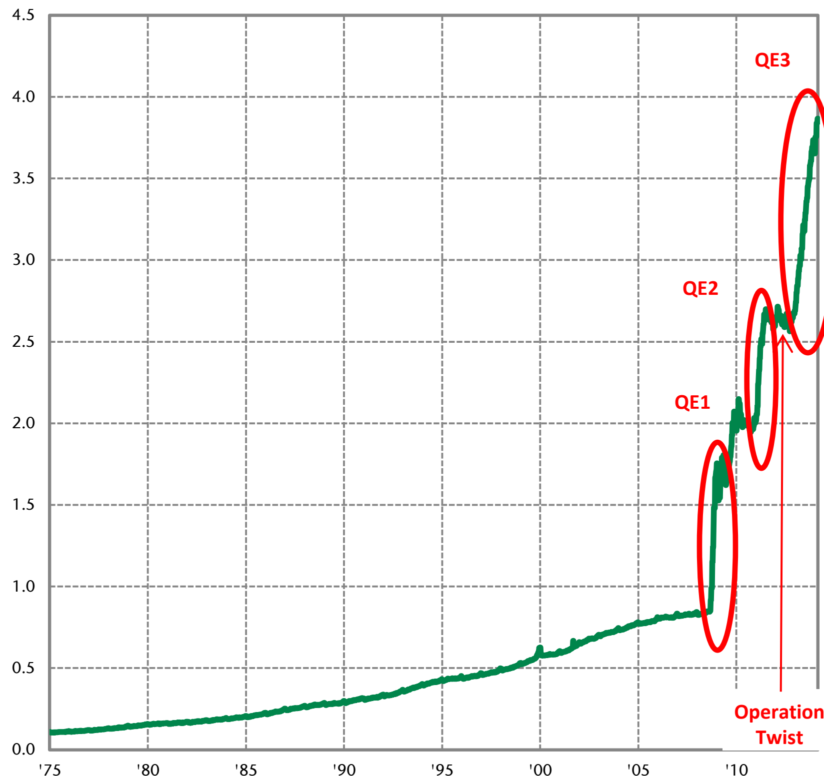
The single most important driver for ALL global asset prices is the aggressive and unprecedented moves in global central bank balance sheets.

Total Assets of Major Central Banks ($ Trillion)



US Monetary Base ($T)



Source: NCBs through both Bloomberg and Haver
Source: Bloomberg

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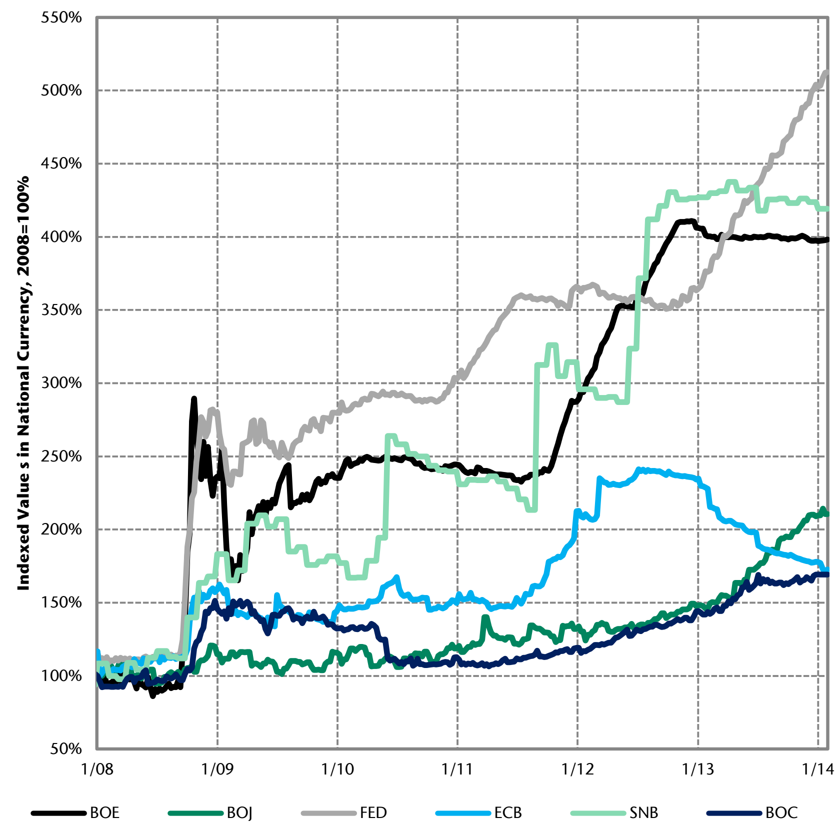
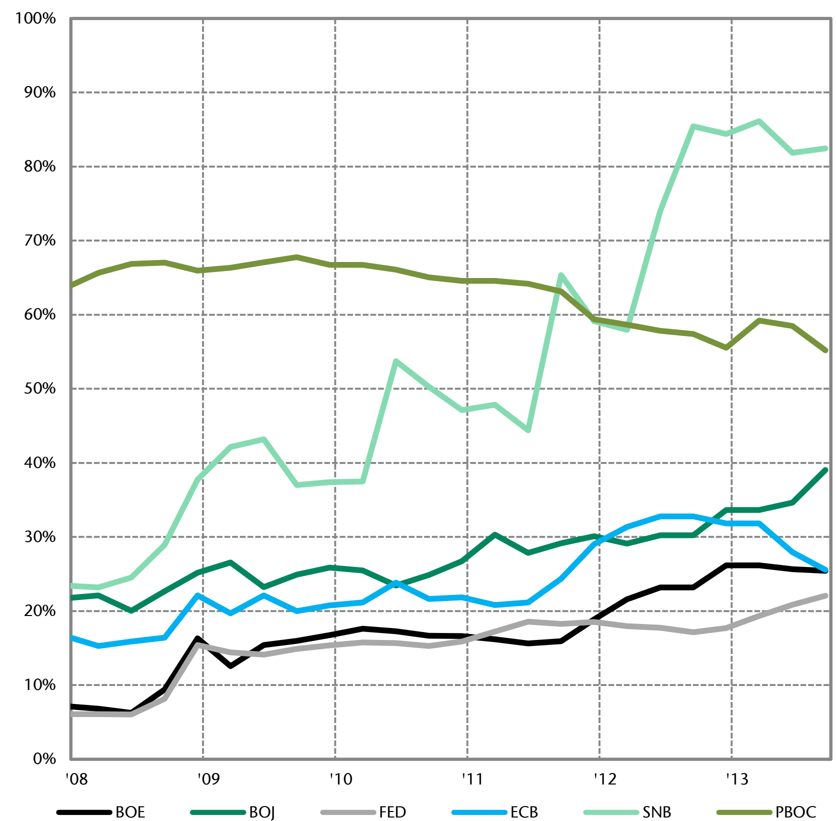
Since 2008 there has been quite a lot of divergence in central bank aggressiveness.

Total Asset Levels of Major Central Banks



Central Bank Total Assets as a % of GDP



For Both, *Source: National Central Banks: balance sheets and GDP figures*

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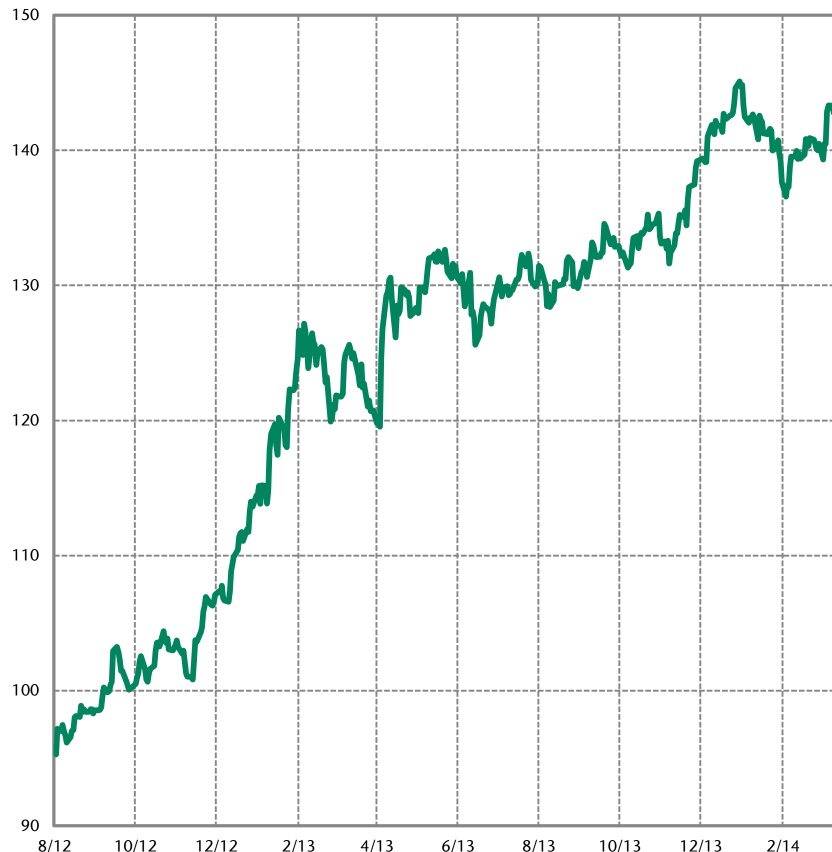
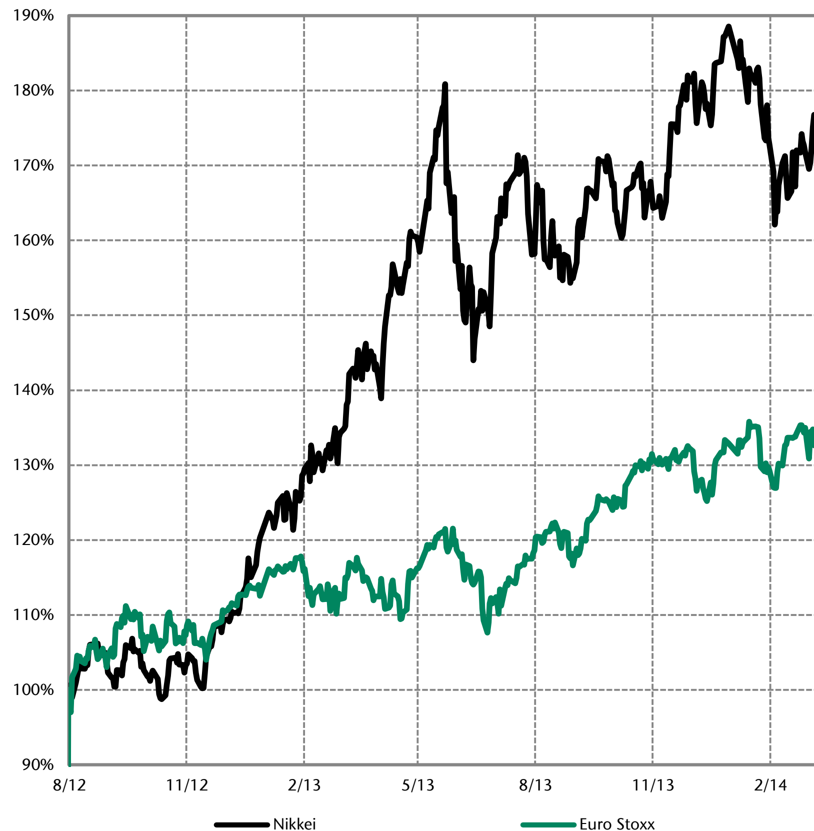
The story for the last 15 months has been the BoJ's commitment to catch up, and the ECB's reluctance to stay the course. This has played itself out aggressively in EURJPY and the relative outperformance of the Nikkei vs EStoxx. This trend will likely continue throughout 2014.

EURJPY Currency



Change of Nikkei and Estoxx (Aug. 2012=100%)



Source: Bloomberg

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As we look across developed markets inflation remains subdued, but Japanese inflation is finally starting to look more "normal". Who would have thought Japanese inflation would running ABOVE US, Italian, French and German inflation in 2014!!!! If QE is actually applied with the correct it works just fine!!

World Inflation (YoY %)

US, Germany, Japan, UK, France, Italy, Canada

Source: OECD, NCBs, Bloomberg

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GDP growth has been accelerating nicely in the US, Japan, and the UK. Is it any coincidence that these are the countries with the deepest commitment to central bank balance sheet expansion!

Real GDPs (Jan 2008 = 100)

108
106
104
102
100
98
96
94
92
90

1/08 7/08 1/09 7/09 1/10 7/10 1/11 7/11 1/12 7/12 1/13 7/13

US France Germany Japan Italy UK

Source: OECD, NCBs, Bloomberg

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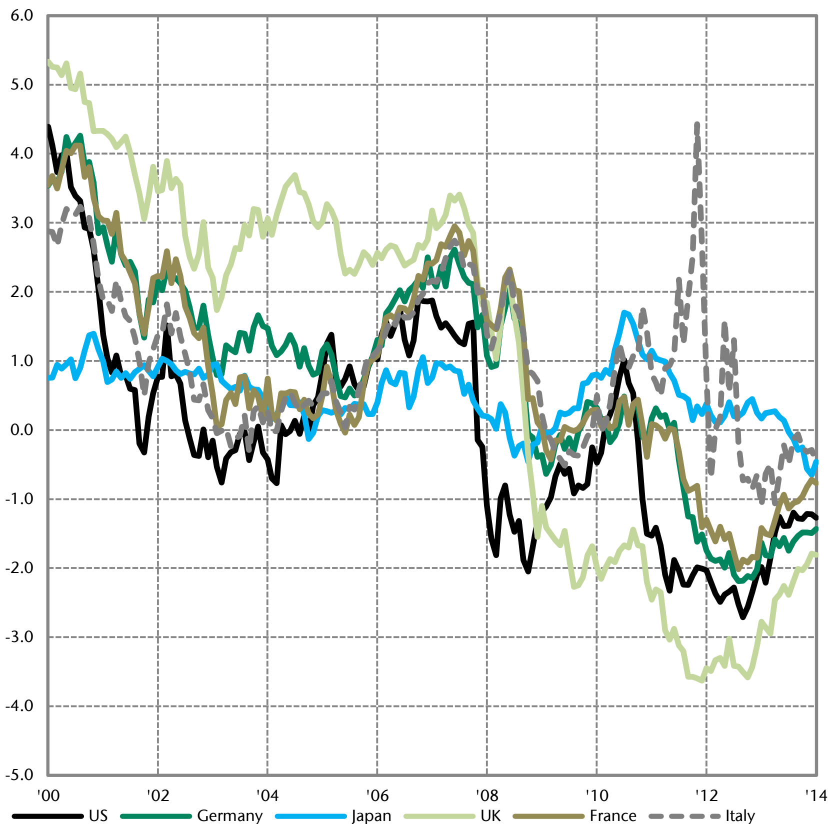
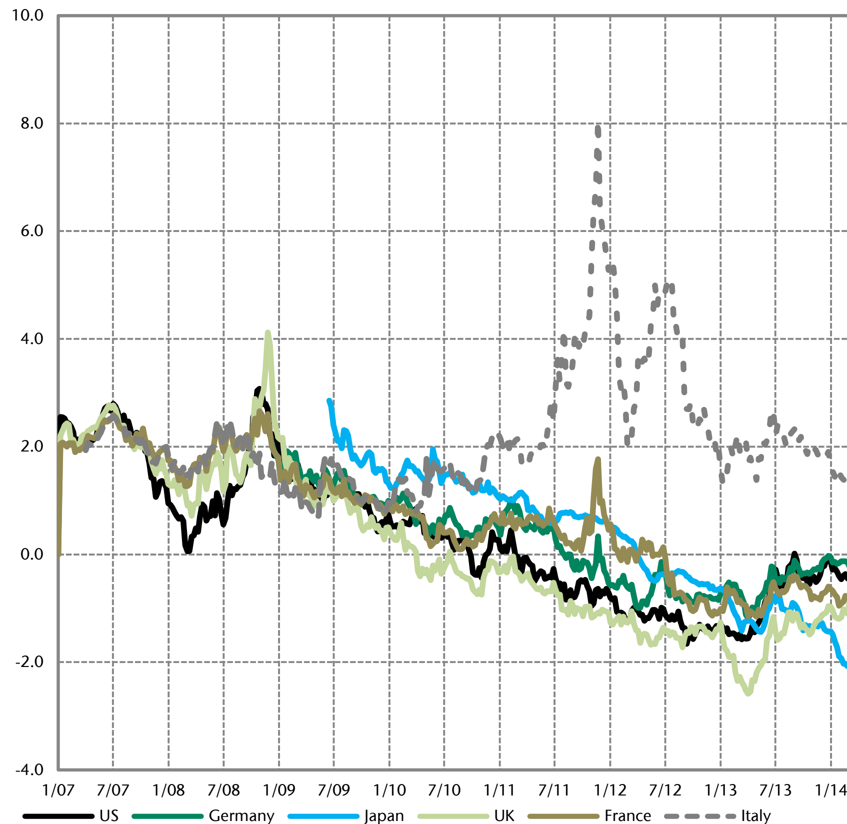
Short term real interest rates provide the best indication of the stance of monetary policy. Ex-post real short rates have moved sharply lower since the crisis, but they are on the rise except in Japan. Ex-ante real short rates have a similar pattern. Overall real rates remain in "the highly accommodative zone" across most developed markets. The sad exception to all this is the periphery of Europe!

Real Rates of Developed Countries



5 Year Implied Real Yields



Real Rates, *Source: Bloomberg (2yr yields – 2 Year Annualized Headline CPI)*
Implied Real, *Source: Bloomberg (5yr yields – Breakeven Inflation)*

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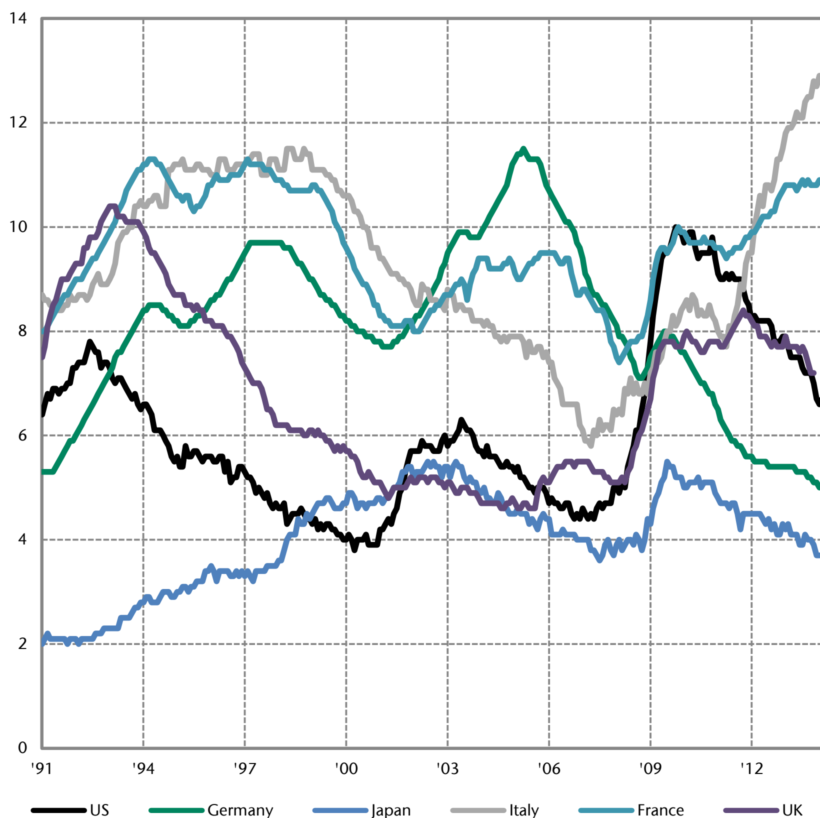
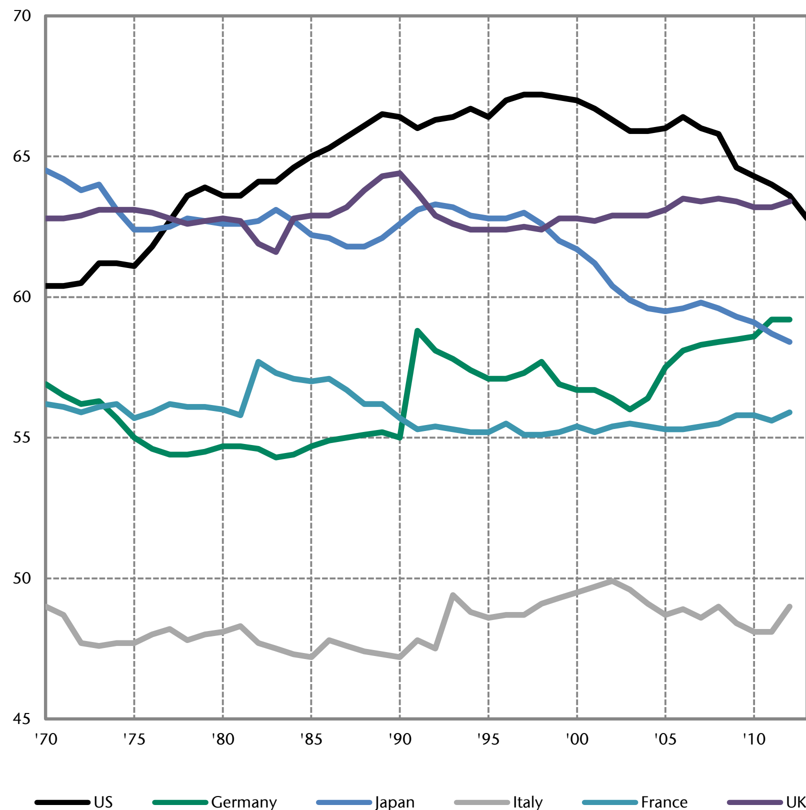
As long as real rates fall enough - policy becomes accommodative, inflation rises and unemployment falls…in other words QE WORKS!!!! But if real rates are not pushed low enough, unemployment and disinflation problems remain. That was the problem in Japan for 20 years and it's the current problem in the periphery of Europe. Complicating the employment picture however are changes in the participation rate. Central bankers can never really be sure if there is truly slack in the economy or if there are structural and demographic issues in play.

Unemployment Rates (%)



Participation Rate (%)



Source: Bloomberg

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But based on what we know about the US from the FOMC's summary of economic projections (SEP). FOMC sees A LOT of slack in the US economy – even at equilibrium at the end of 2016. How else could you explain these forecasts?

December 2013				
FOMC SEP (Midpoint of Central tendencies)	2014	2015	2016	Longer run
Change in real GDP	3	3.2	***2.9***	2.3
Unemployment rate	6.45	5.95	***5.5***	5.5
PCE inflation	1.5	1.75	***1.9***	2

September 2013				
FOMC SEP (Midpoint of Central tendencies)	2014	2015	2016	Longer run
Change in real GDP	3	3.25	2.9	2.35
Unemployment rate	6.6	6.05	5.65	5.5
PCE inflation	1.55	1.8	1.85	2

Target federal funds rate at year-end		**2014**	**2015**	**2016**	**Longer run**
Sept	Mean	0.40	1.25	2.26	3.93
	Median	0.25	1	**2**	**4**
Dec	Mean	0.34	1.06	2.18	3.88
	Median	0.25	0.75	**1.75**	**4**

Source: Federal Reserve Bank

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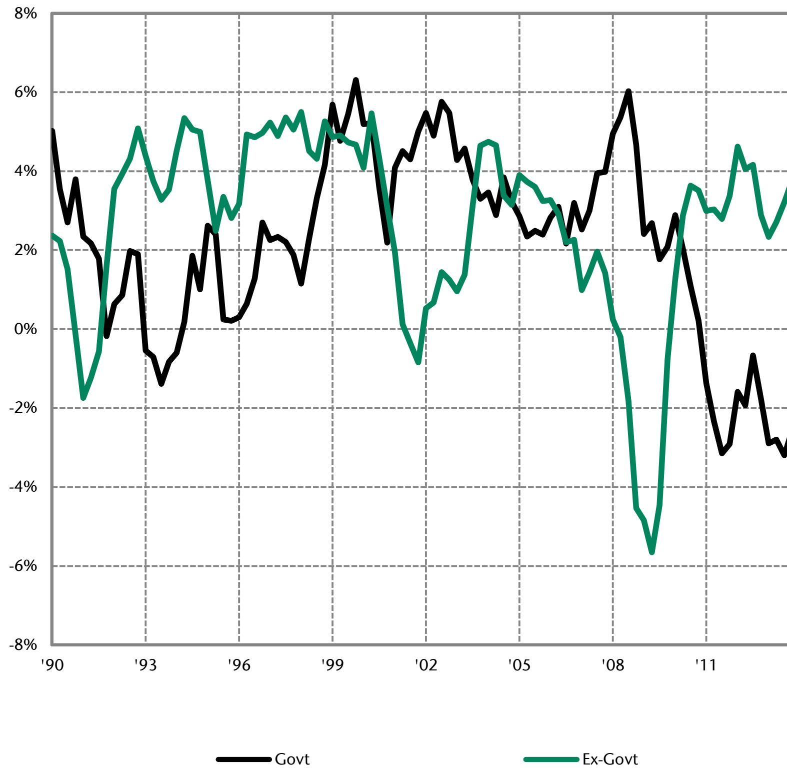
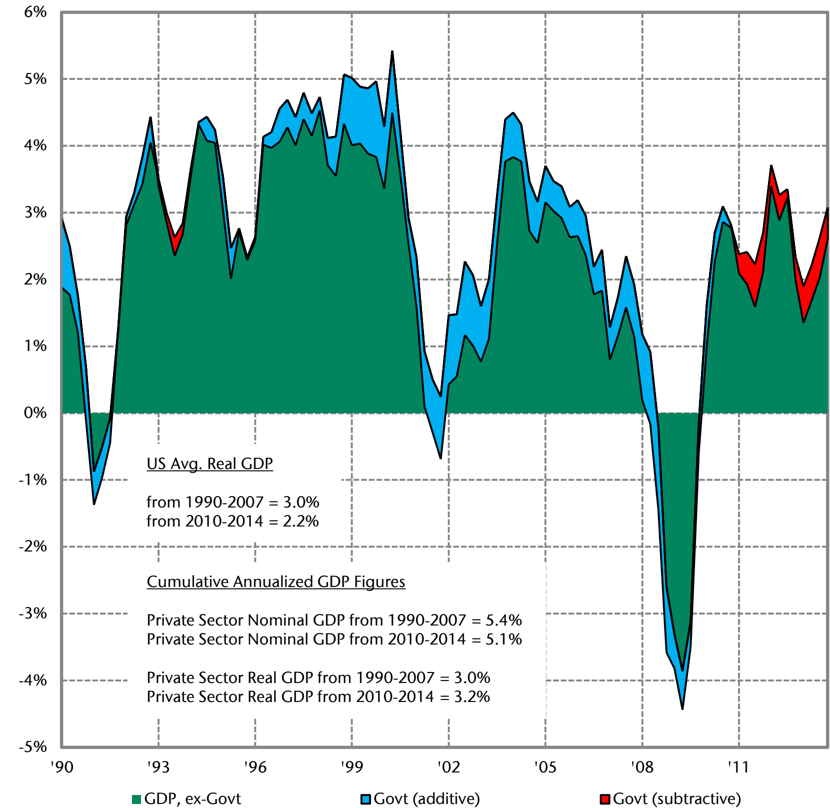
But as much as the Fed sees slacks, the private sector has performed remarkably well post crisis.

Real GDP of Govt and non-Govt Sectors (YoY, %)



US Real GDP, by Component (YoY %)



Source: Bloomberg, Jefferies

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The FOMC looks like it will be taking some significant longer term inflation risks in order to unwind slack associated with a falling participation rate. And the BoJ finally looks like is will apply QE in such a way as to keep risk free real rates low and negative. But the Europeans are just flailing in the wind. The ECB got it right in the beginning of the crisis, but since the summer of 2012 they have let the trade weighted Euro appreciate sharply. The ECB is making the same "relative" mistake the Japanese made during their lost decades. That is why they have high real rates, a weak economy, a strong currency, strong bond markets and weak equity markets! It's a tragic mistake!

Trade-Weighted 20-Country Euro NEER

Source: Bloomberg, ECB

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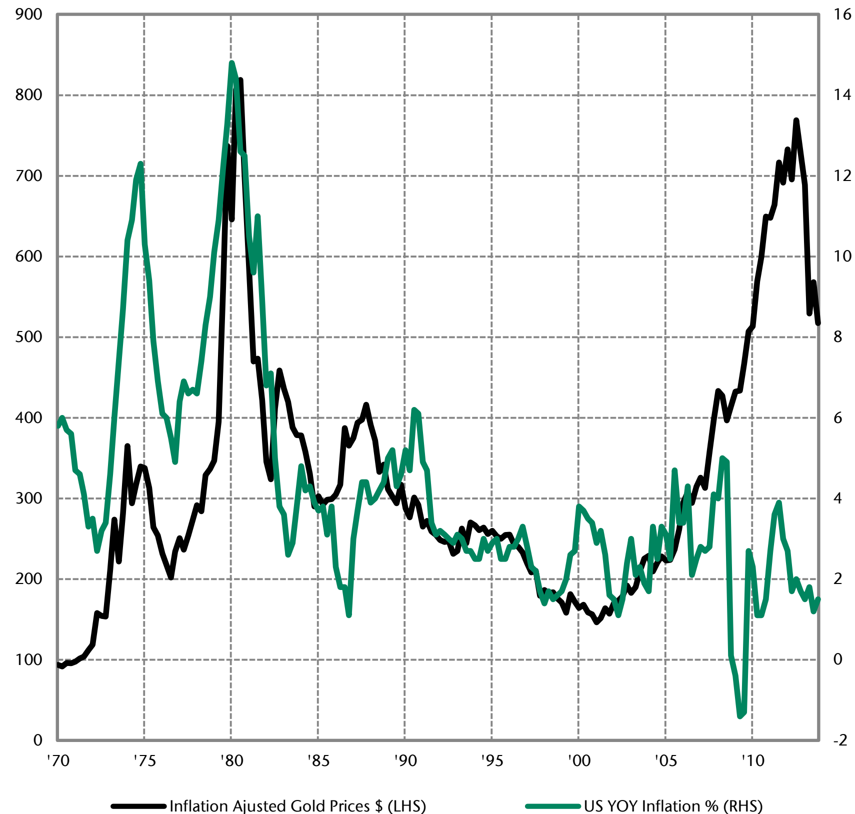
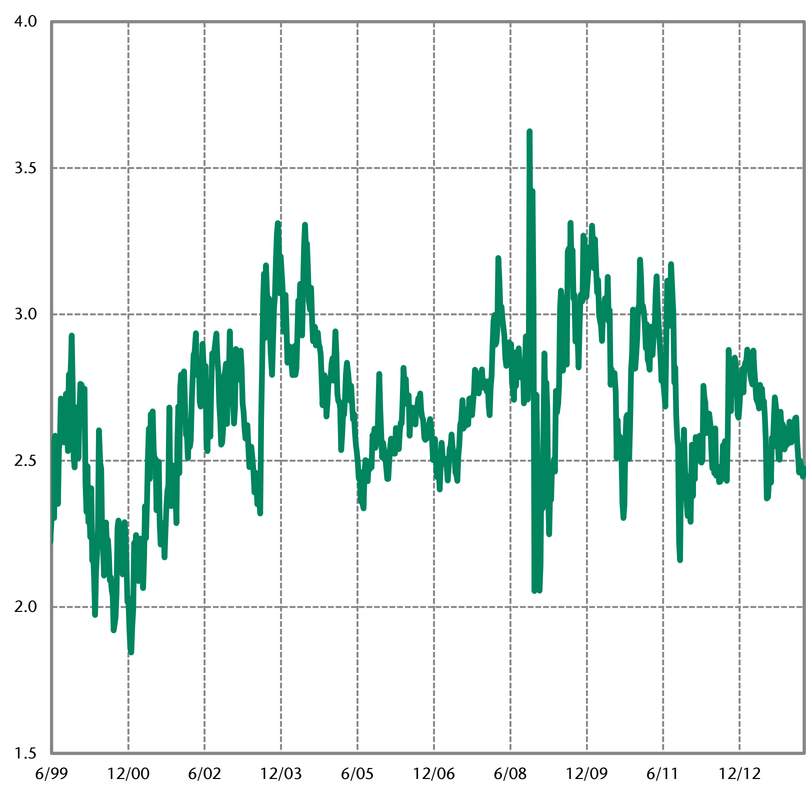
Looking ahead, there are surely long term developed market inflation risks associated with all of this monetary expansion. And while breakeven inflation rates suggest these risks are minimal, Gold still prices in some serious long term inflation dislocations. So far though the breakevens seem to winning the battle! But there is no question, over the long run, the developed market central banks are taking significant risks with long term inflation stability.

Inflation Adjusted Gold Prices (indexed to 1983)



Fed 5y5y Breakeven (%)



Source: Bloomberg

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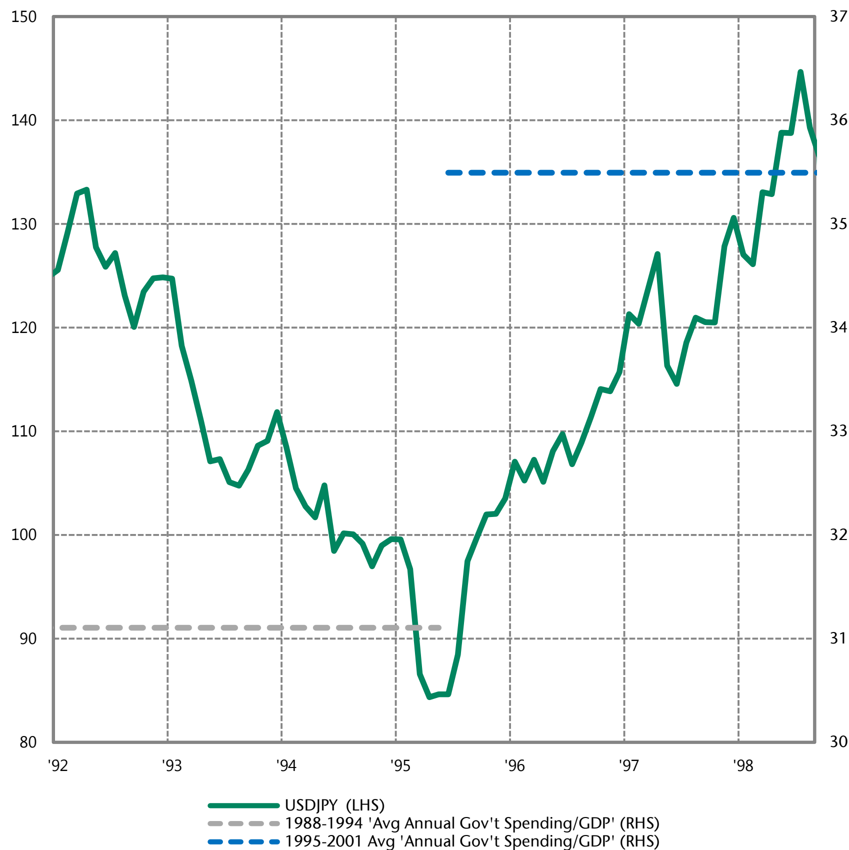
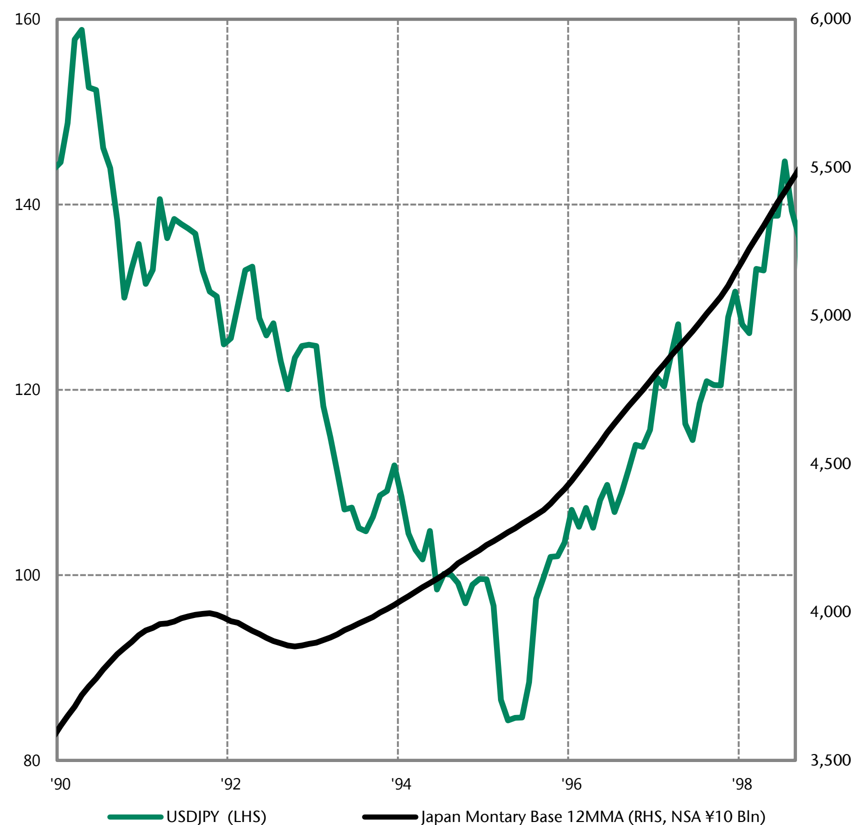
Near term, as developed market central banks push the printing press pedal to the metal, force risk taking and generate increased real growth potential, EMG will become the weak link - remember the last time US rates started to rise, a US recovery took and Japan went on a devaluation tear by using a combination of expansionary fiscal and monetary policies.

Japan's Fiscal Expansion Post the 1995 Yen Lows



Dollar/Yen & Japan's Monetary-Base



For Both, *Source: National Central Banks: balance sheets and GDP figures*

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It did not end well for EMG. And take a look at the relative value of SPX to MXEF - EMG looks VERY expensive!!

SPX/MXEF Ratio (1988=1)

Source: Bloomberg, MXEF is a free float weighted emerging market equity index.

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Here are the winning and losing assets in the great reflation.

There Are Two Types of Assets

Non-Printable	Printable
• Equity Capital • Real Estate • Commodities • Distressed Fixed-Income Assets	• Cash • Low-Yielding Fixed Income Instruments

In a world where the developed market central banks drive risk-free real rates lower, and the portfolio balance channel forces risk taking, two things can happen. The risk-taking generates innovation, technological advance, productivity gains, real returns on capital, real growth and job creation; or, the risk taking does generates no innovation, no technological advance, no productivity gains, no real returns on capital, no real growth and no job creation. Folks who believe in the former – the lovers - should own equity capital, real estate, and distressed assets. Folks who believe in the latter – the haters - should own commodities such as precious metals. No one should own printable assets - anyone who does so will be in the "loser" camp.

Winners	Losers
• Nikkei • S&P • DAX • Real Estate • Distressed Fixed-Income Assets	• Cash • Low Coupon Bonds • Emerging Market Assets

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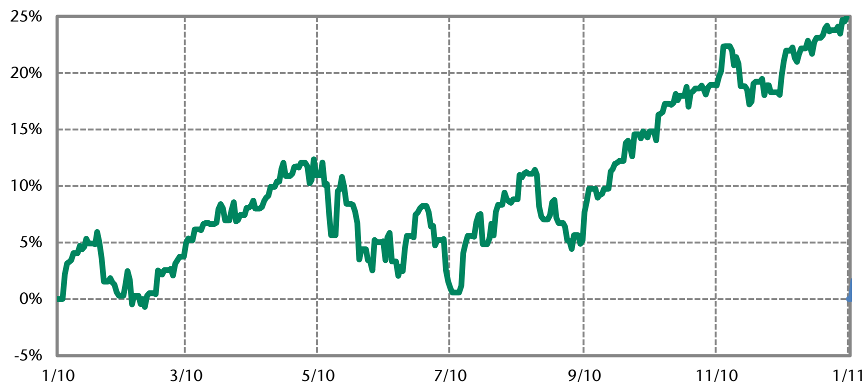
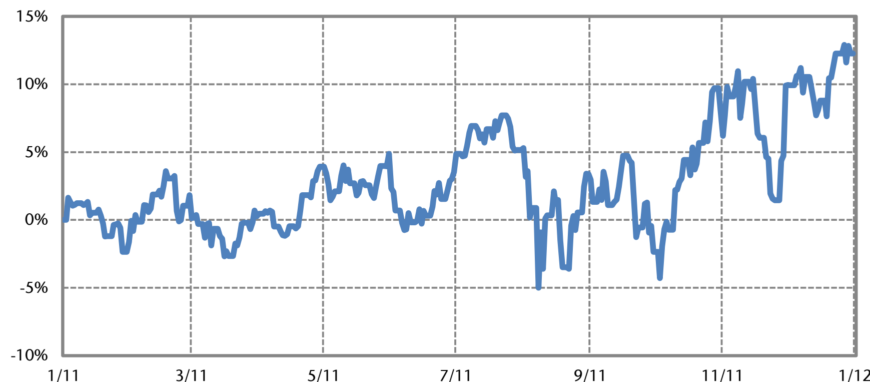
Our favorite way to play the great reflation has evolved through time. In general we have always recommended at "long/long" strategy. For every 100m of risk assets (ie SPX), we would hedge with 100k/01 in 2s, duu's, blues or chartreuse. For 2014 we are fully risk-on. No more levered fixed income hedges in the front-end. It's time for just Spoos and Q's!!!

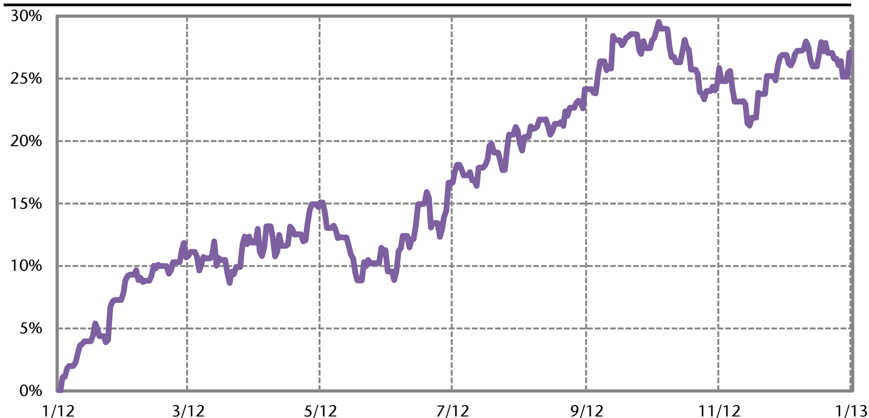
2010, SPX & 2s



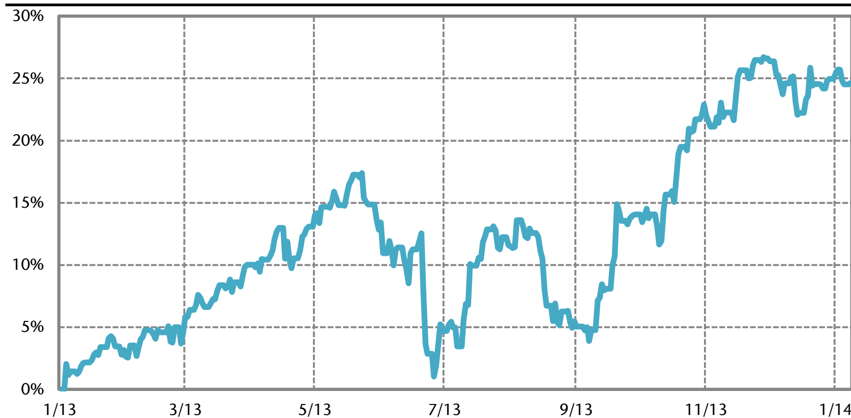
2011, SPX & DUU's



2012, SPX & Blues



2013, SPX & Chartreuse



Source: Bloomberg, Jefferies: -Using weightings of $100K/01 for every $100m in equities.

Glossary: SPX is the S&P 500.... DUU's refers to Schatz futures contracts .... Blues are blue (3 yrs out) Eurodollar futures contracts .... Chartreuse is blue and green (2 and 3 yrs out) Eurodollar future contracts

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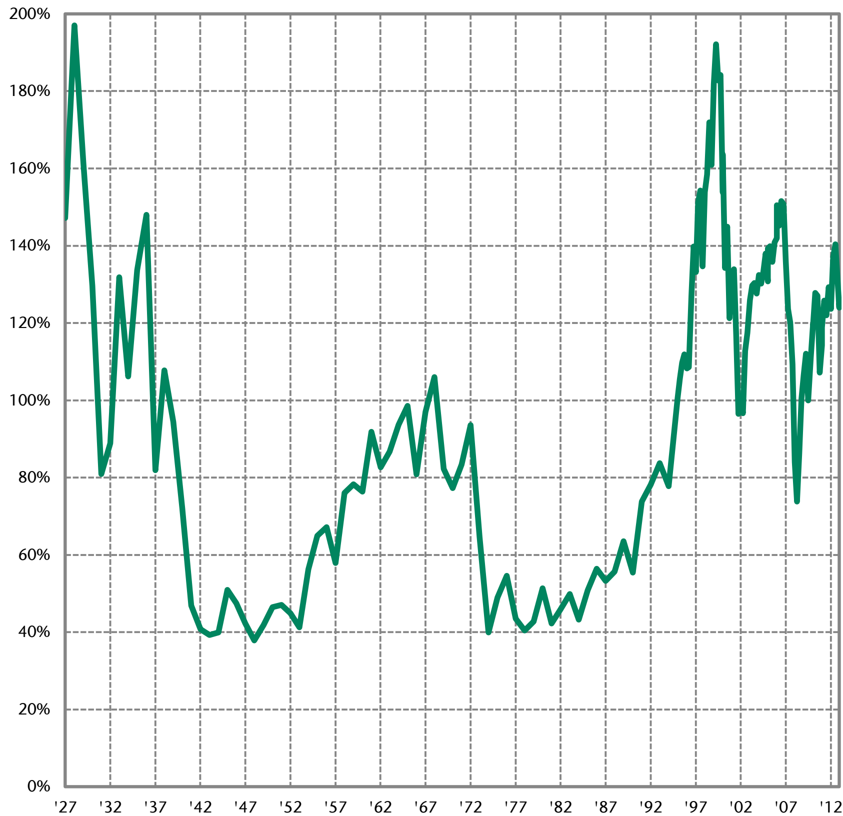
The Fed backstop is fully in place, QE has worked its magic and US equities do not look expensive.

Total US Equity Market Cap/GDP



Real Value of US Equities (in 2013 dollars)

Source: Bloomberg, Fed, Jefferies.

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Meet the new bubble....same as the old bubble.

Adjusted Nasdaq Composite Index (Jan 1990 = 100%)

1,200
1,000
800
600
400
200
0

'90 '91 '92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13

GDP Adjusted CPI Adjusted

Source: Bloomberg.

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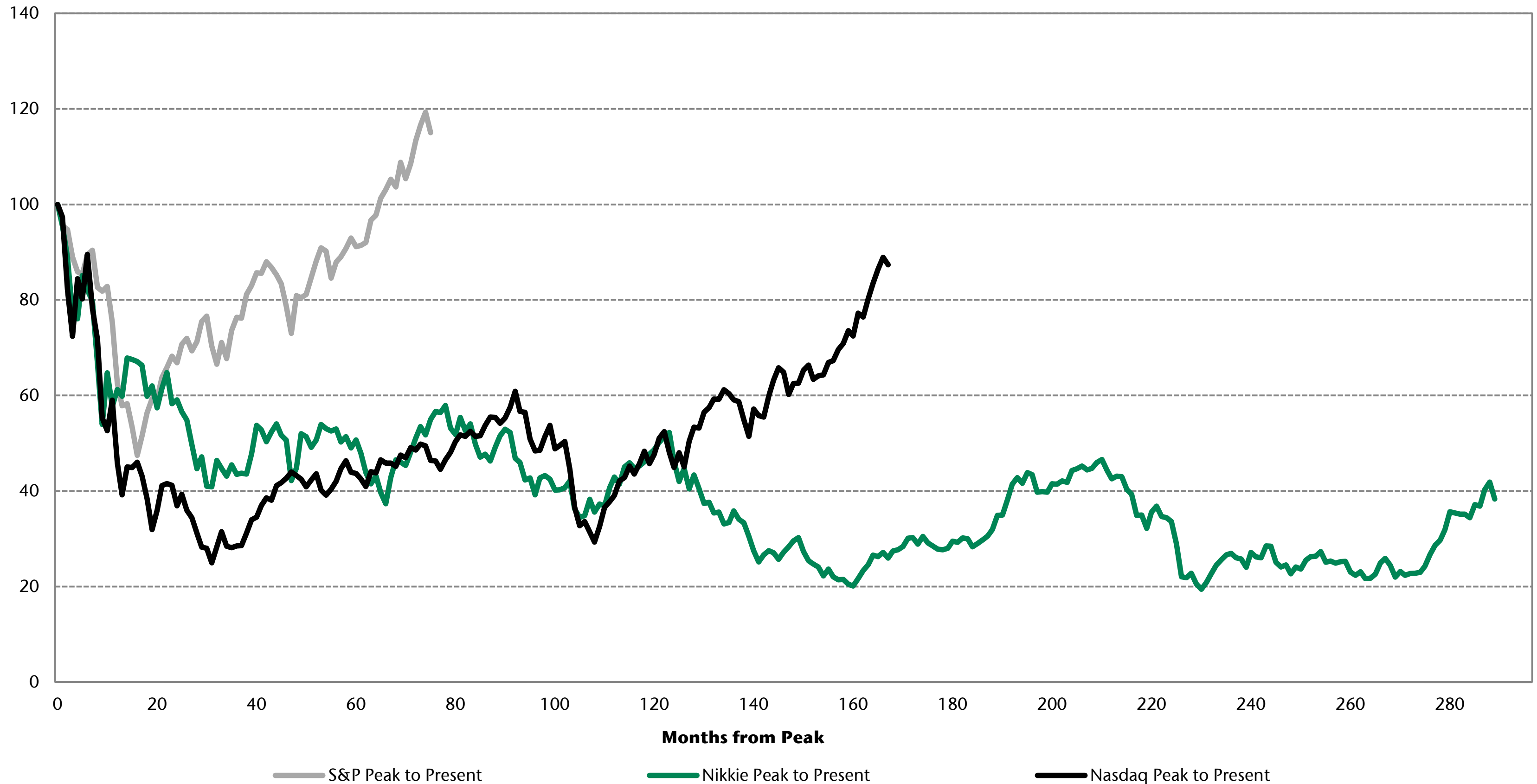
The most important lesson from the CORRECT implementation of QE is that the US is NOT Japan.



Source: Bloomberg, Jefferies.

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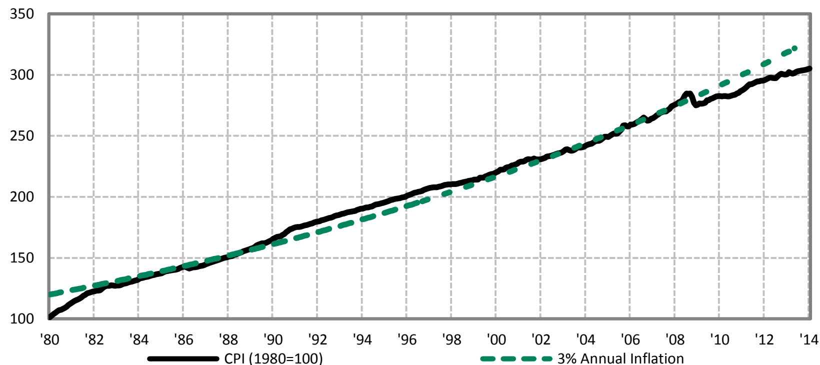
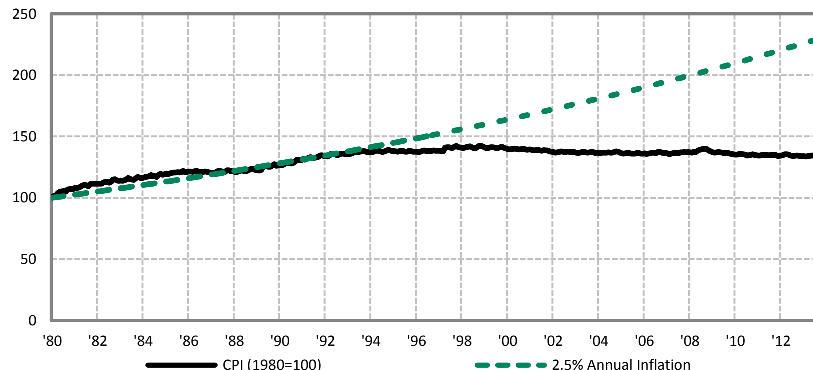
The greatest monetary policy mistake since the 1930s took place in Japan, from 1990 to 2013.

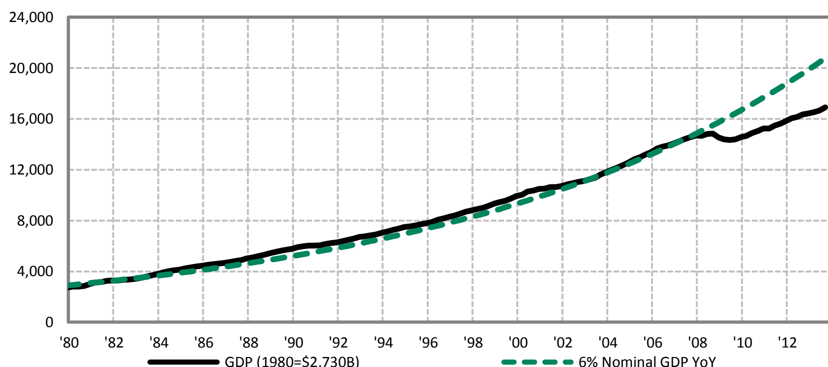
US Price Levels (1980=100)



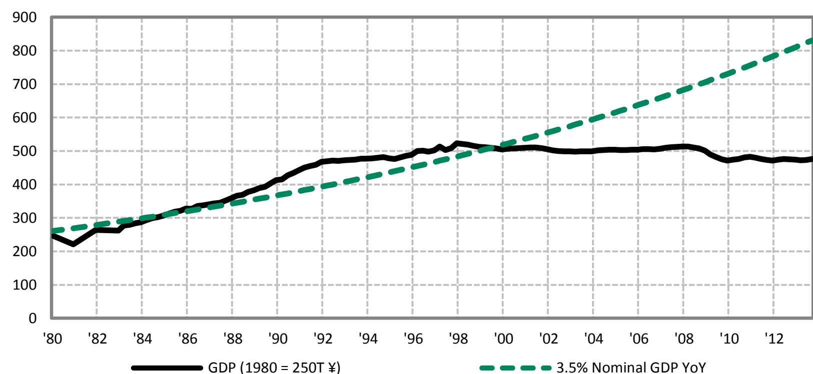
Japan Price Levels (1980=100)



US GDP



Japan GDP



Source: Bloomberg, Jefferies.

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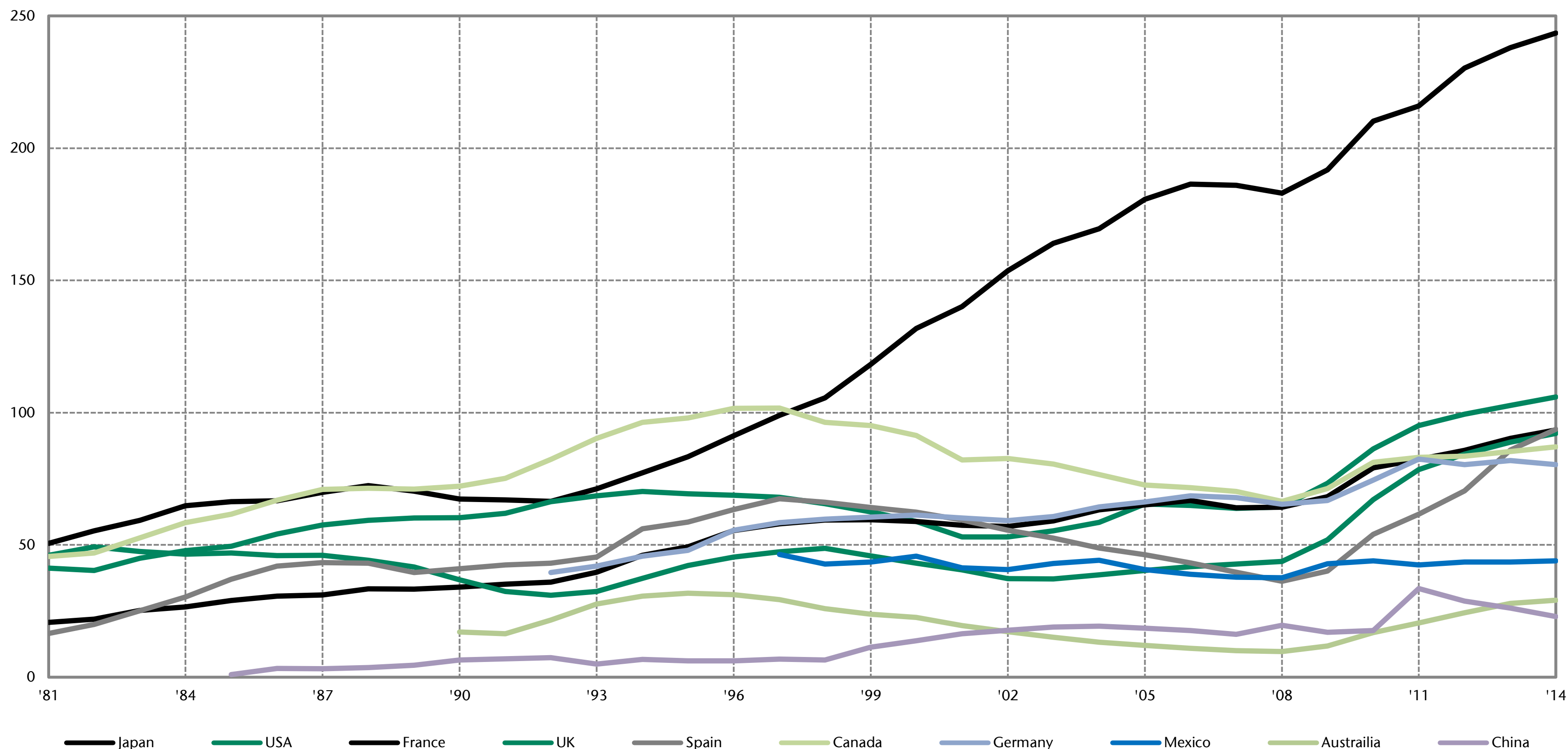
Sadly, Japan relied on fiscal policy expansion instead of monetary policy expansion to spur a recovery….that clearly did not work out very well.



Source: Bloomberg,.

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The bottom line is that we have seen some amazing benefits from QE when it is appropriately applied. However, like any pain medication, the benefits are very much upfront and the costs are much long term. What are some of these long term costs:

1. Financial instability/bubbles
2. Losses on the balance sheet
3. Inability to extract reserves and control short rates on the exit
4. Unhinging of long term inflation expectations
5. Income and wealth distribution skews

All of these are serious issues for the long run, but the most worrisome one is the income distribution skews. We are likely to see much more political instability in the US over the long run as QE continues to widen these skews. Let's look at a few charts on the negative distributional consequences of US QE.

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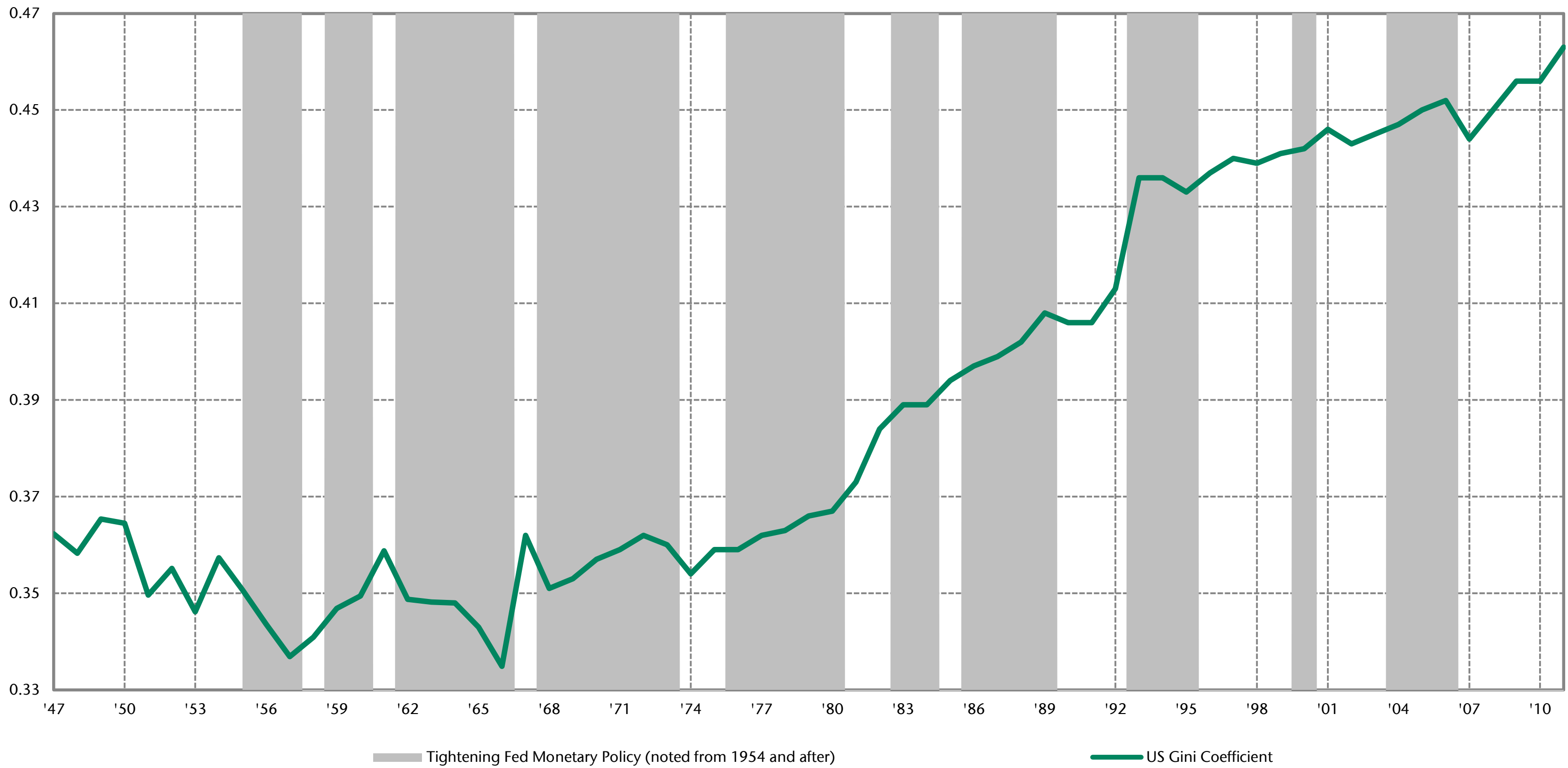
A worrisome trend developing.

US Gini Coefficient



Source: Bloomberg, US Census.

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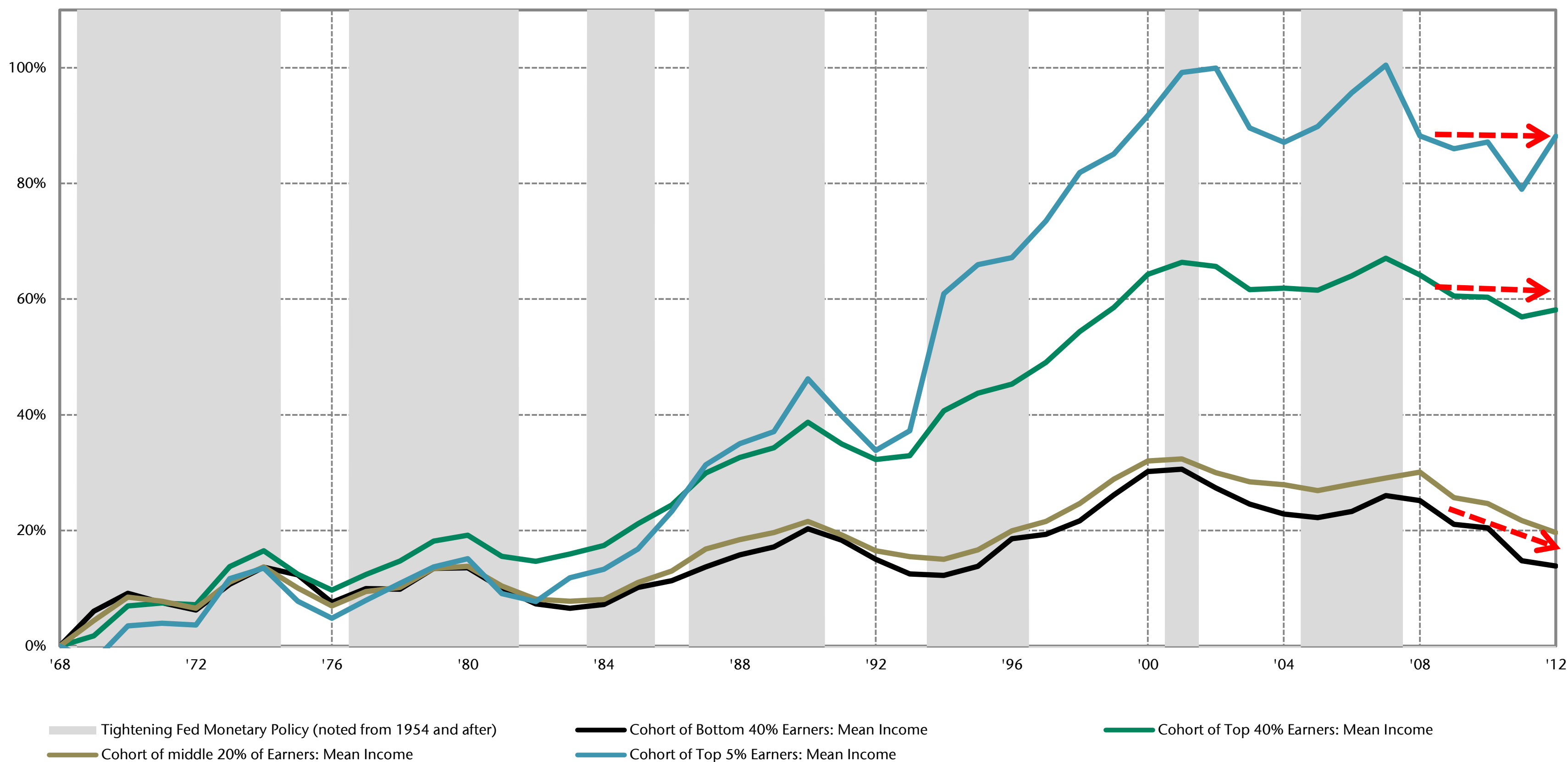
Income has stayed the same for the upper class, but has fallen for the middle and lower-tier earners.

US Cumulative Real Income Increases since 1967, by Income Cohort



Source: US Census.

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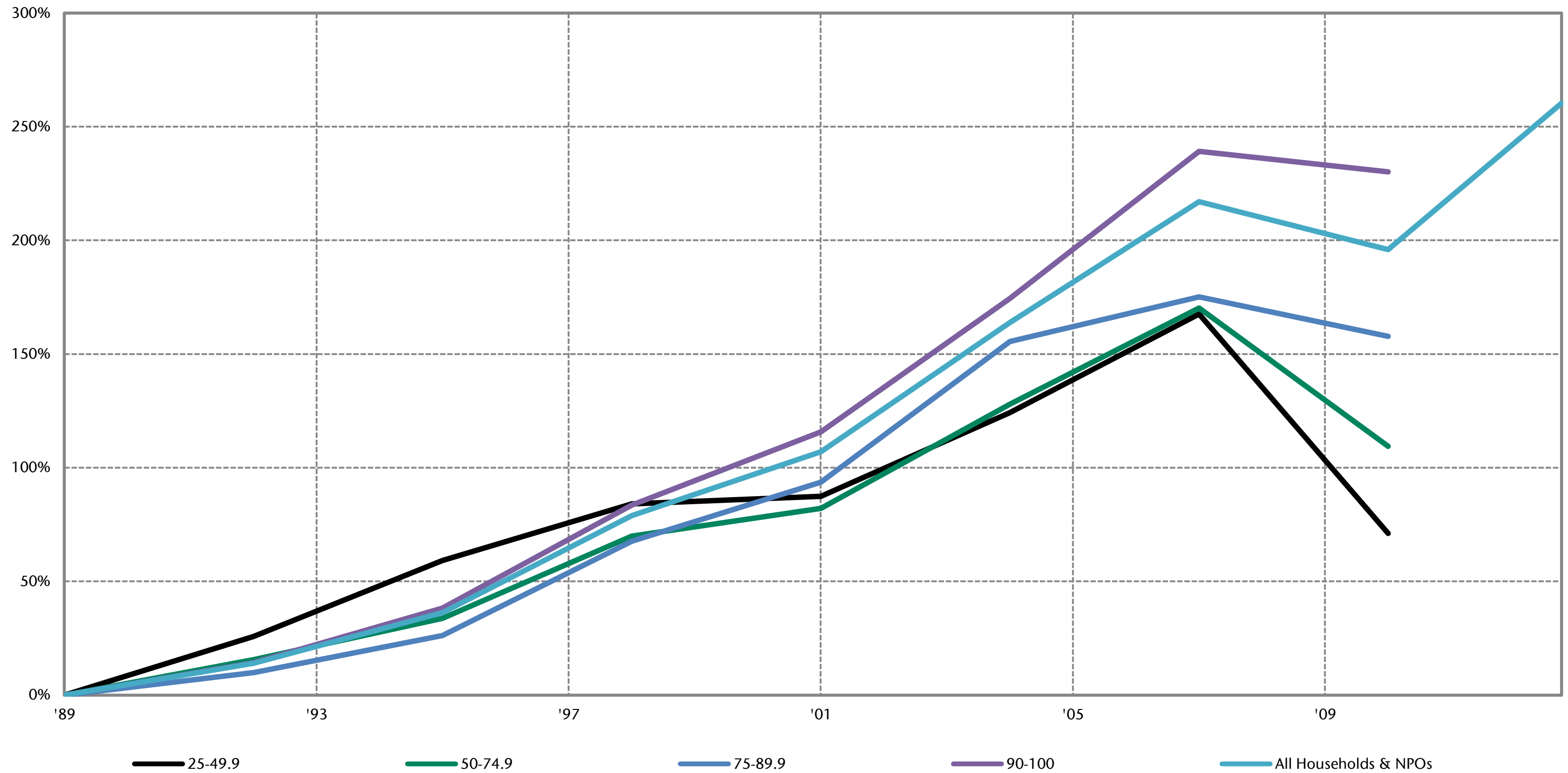
The wealth distribution has also widened sharply.

US Household Nominal Wealth Growth Since 1989 by Cohort



Source: US Census, Fed., Jefferies.

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Big house, low rate - small house, high rate.

Average Original Loan Size ($K) by Net Coupon(%) (Fannie & Freddie 30-yr, Conforming and Non-Conforming)

Source: Five Bridges Advisors, Sept '13.

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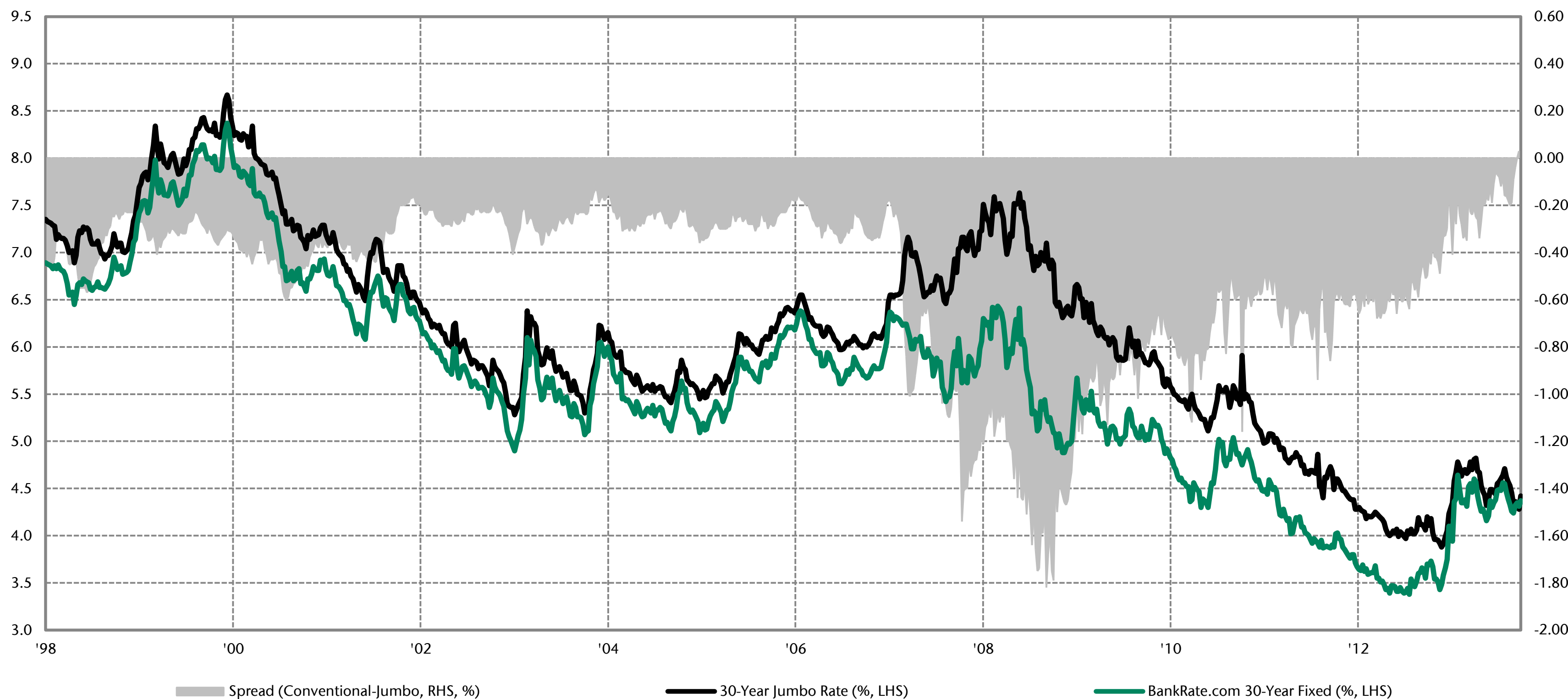
Recently the jumbo-mortgage rate has dipped below the conventional mortgage rate.



Source: MBA and Bankrate.com.

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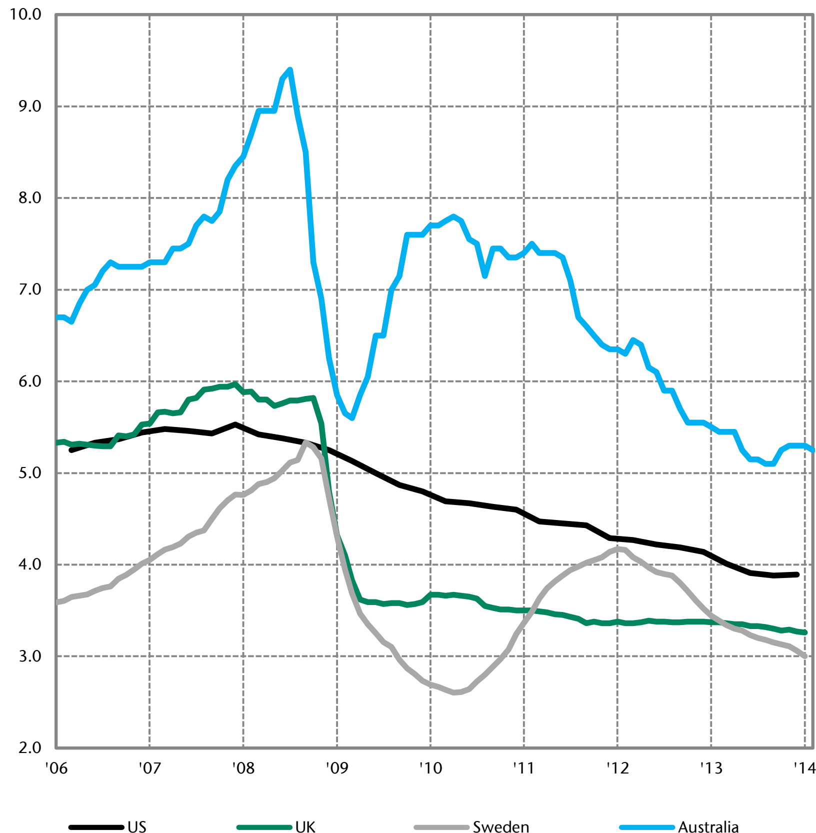
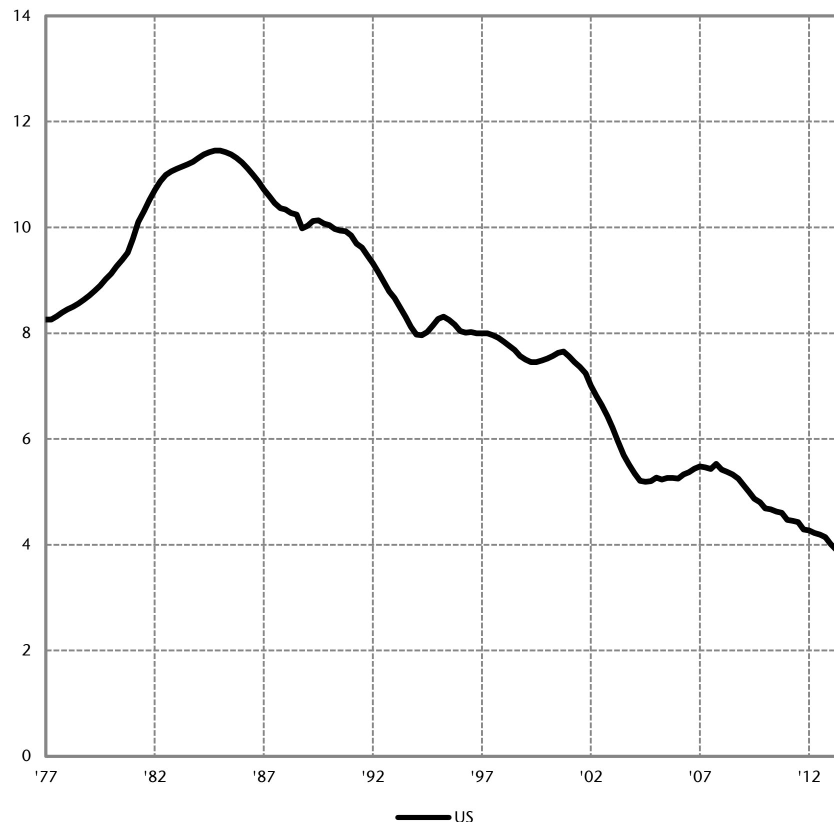
The structure of the US mortgage market is the culprit behind these distributional asymmetries. A fixed rate mortgage combined with a house price collapse is a toxic structure. The biggest problem for the US has been the inability of those in the lower income quintiles to refinance. The Fed should have thought more clearly about these distributional issues back in 2009!!

Effective Outstanding Mortgage Rates (%)





Source: Fed, SCB, RBA, BoE

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