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Markets in High Resolution

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# The Q1 Refaltion Trade

The Q1 Reflation trade is underway. While some apprehension is understandable after a great run in risk assets, we are in a sweet spot in terms of policy risk. **Fading the rally is not recommended**, although continued participation **will soon require confirmation of improved liquidity conditions**.

On Monday we dissected the myth that QE is driving the risk asset rally. Today we'll review the benign policy backdrop and highlight some liqudiity indicators we'll be looking to for confirmation of a further upside.

## China: Annual "Tone-Setting" and Phase One Party

It's silly season in China. And with the Phase One deal signing anticipated next week, it'll be sillier than ever.

It's the time of year when the economic propagandists "set the tone" for the super-fantactic year to come. The economy will grow at 6%, "reform will deepen," "market opening will accelerate," authorities vow to "control risks," policy trasmission in all dimesnions will be improved, and PBoC actions will be "prudent, flexible, appropriate," and otherwise just goddamn perfect.

Lather all the blather with half a Trillion Dollars in new bank lending in January and a heavily front-loaded muni bond calendar, and what's not to like for the momentum-driven investor (which predominate in a market where the news is fake and the financials flaky)?

This year's outlook is extra rosy because Xi Jinping is "winning the trade war." [I'm only being moderately sarcastic here – China definitely got the better of Phase One].

**The CCP won't allow the aftermath of the Phase One signing to produce anything other than sunshine and roses** for Chinese asset markets and the RMB.

In the end, 2020 will prove no better than 2019 for the moribund Chinese economy. The propaganda party will create a great opportunuty for a relative sale of Chinese equities at some point in coming months. That point is not now.

In fact, **my favorite risk-reward trade right now is to be long the flimisest major currency on the planet**. How do I know the RMB is going to rally? The Global Times told me so yesterday:

> *As yuan-denominated assets are increasingly traded in global markets, they will drive up the demand for the currency and its value will rise.*



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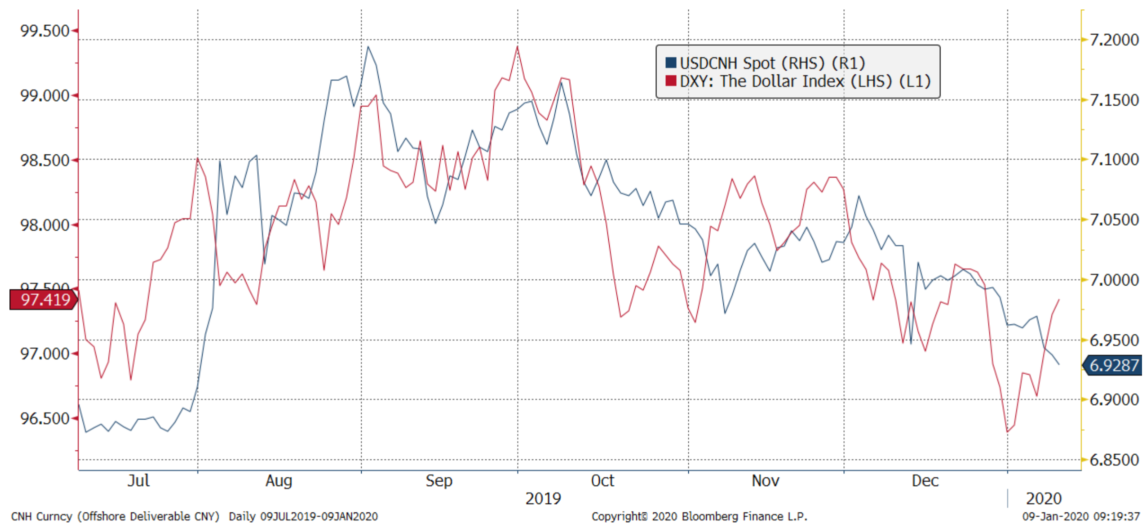
> *Such a trend parallels a global "de-dollarization" move. The dollar's international standing has been undermined by the trade war the US launched against its trade partners and the sanctions it willfully imposes on others who do not yield to its bullying policies. Many countries have been prompted to double their efforts to create an alternative to the dollar for trade settlements and transfers.*
>
> *The yuan is an ideal currency for diversification away from the dollar.*

All utter nonsense of course, but the geopolitical and domestic **imperative is that the RMB react positively to the Phase One deal**. Given PBoC's heavy-handed control over FX supply and the lack of any apparent trigger for locals to fight official desires, it's a safe bet the RMB will continue to rally. I'm looking for 6.80-6.85 in coming weeks.

Notably, USDCNH has bucked the YTD trend of DXY strength:




Fed Policy: Positive Asymmetry

The current Fed set up is unique both in recent history and across markets. U.S. financial markets enjoy a policy asymmetry in which for the foreseeable future **the central bank can and will ease if necessary, but will not tighten under any circumstances**.

The tension between the Administration and the Fed runs much deeper than a disagreement over the proper level of the funds rate. The Fed's institutionally embedded framework is ill-suited to the Trump Administration's world view and agenda. As I wrote over a year ago:

> *Powell's problem is the Fed's framework - a misguided model in which inflation is driven by the "output gap" based on static and uncertain estimates of "potential growth." Given their*



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> *assessment of the economy being at "full employment," the framework tells the Fed it must now cap real GDP growth at 2% at all costs.*
>
> *While Powell has inherited this framework, he must have understood when he accepted the post that it was in direct contradiction to the goals and agenda of the President who was appointing him.*

Despite its institutional proclivities, the Fed might have acknowledged that a healthy electoral majority had installed an Administration that ran openly on the proposition that supply-side enhancements could generate 3%+ GDP growth in a non-inflationary manner. Instead, the Fed effectively said "no, we don't believe that, and we won't allow it."

Is that their place as a nominally "independent" creature of Congress? That is a political question that will be settled in the court of public opinion.

But if the Fed wants to have that political battle it'll be for all the institutional marbles. Do they like their chances against a master persuader with the biggest public policy microphone history (who, for the repeated failings of the Phillips curve model, may actually have the facts on his side as well)?

No, they do not. This from Chair Powell's December presser:

> *STEVE LIESMAN: You've used the analogy to 1998 to describe the rate cuts we just went through, and I'm wondering if we can sort of continue the analogy. Within seven months of those '98 rate cuts, the Fed took them back and then some. So, were these those kind of rate cuts, the kind that you need to take back, or are we at a place now where we're at a neutral rate—"take back," I mean if those risks that you say we're cushioning from don't materialize in the way you think—or is this now a new sort of steady state for the economy at this rate, this is the right rate for the economy that you see going forward and don't need to take those rate cuts back?*
>
> *CHAIR POWELL: What's different is, you have a very different—you have very different structural characteristics in the economy, particularly around inflation. So now, as you can see, inflation is barely moving up, notwithstanding that unemployment is at 50-year lows and expected to remain there. So, the need for rate increases is less. And, by the way, this is—it's a good thing that, you know, we think we can—**I think we've learned that unemployment can remain at quite low levels for an extended period of time without unwanted upward pressure on inflation**. In fact, we need some upward pressure on inflation to get back to 2 percent.*

The Fed is not simply "on hold" for a while. They are in the process of an intellectual and political



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capitulation with powerful ramifications for the distribution of expected future GDP growth rates. **We're getting the right-hand tail back**!

U.S. Politics

Speaking of right-hand tails, the markets should also benefit from the emergence or a live one in the realm of domestic politics. The modal outcome for 2020 seems fairly settled: a status quo result of a Republican White House and Senate with Democrats maintaining control of the House. I envision the consensus as having a large left-hand tail to this distribution in which the Democrats take back the White House, and perhaps even the Senate.

But there is a right-hand tail that is at least equally as likely, if not more so: that is, if Trump wins he takes the House as well.

The simplest argument for this is the 'coattail effect.' Senate and House races are inevitably influenced by the top of the ticket. In assessing the robustness of the Dem House majority its easy to underestimate the degree to which midterm elections are a different animal.

Furthermore, the Democrats are scuffling. **The House has impeached the President to no discernible effect** on his approval ratings. What remains of "the center" is sure to question what the point was.

And while there remains plenty of risk in the middle east, events are clearly unfolding favorably for the President:

With the power of incumbency and an approval rating of +11 on economic policy, Trump merely needs quiescence on the foreign policy front to present the Democrats with an extremely high electoral hurdle.

The Risk on the Horizon

This is where China comes back in to the discussion. I disagree with the increasingly prevalent idea that China wants Donald Trump to be re-elected.



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There is no viable Democratic candidate that Xi Jinping shouldn't be ecstatic about seeing take power. Biden and Bloomberg are capitulationists. And Warren and Sanders can talk all they want about human rights, but it'll be largely irrelevant because their domestic policies will prove detrimental to U.S. economic power.

Don't you think China would love to see the U.S. jacking up taxes to fund massive redistribution programs and a multi-trillion Dollar green new deal? If nothing else, the Dollar weakness that would result from a shift to economic progressivism (MMT anyone?) would be of tremendous benefit to China in managing their credit excesses.

As for Trump, I don't know whether he views Phase One as an electorally-convenient pause before resuming an aggressive second-term decoupling agenda, or whether he really just does want to sell a few more beans to balance the accounts. I don't think China knows either, but I would guess **they want to find out before he is re-elected**.

They'll do this by pressing the issue for further tariff rollback before carrying out the Phase One purchase commitments, and certainly well before any Phase Two accommodations are offered, in order to firmly lock the President into a capitulatory purchases-only stance.

This is why I'm not a fan of Phase One even from the perspective of electoral strategy. It looks great in the short-term, but I don't see the structure as sufficiently robust to push the issue smoothly past November.

Liquidity Indicators: The Fly in the Ointment

Of course, we're talking about a "Q1 reflation trade," and it looks like smooth sailing ahead in terms of politics and policy. Unfortunately, **we don't yet have confirmation of the benign shift in liquidity conditions** that will be required for a meaningful further extension of the risk asset rally.

I anticipate these indicators to improve in the coming days as the impulse towards precaution stemming from recent events in the middle east subsides.

I'll conclude with a quick review of the indicators and what we should look for as confirmation of the Q1 reflation trade. If the indicators respond favorably to Friday's payroll release, an aggressively long-risk posture with an EM emphasis will remain in order. Otherwise, taking some chips off the table may be advisable.



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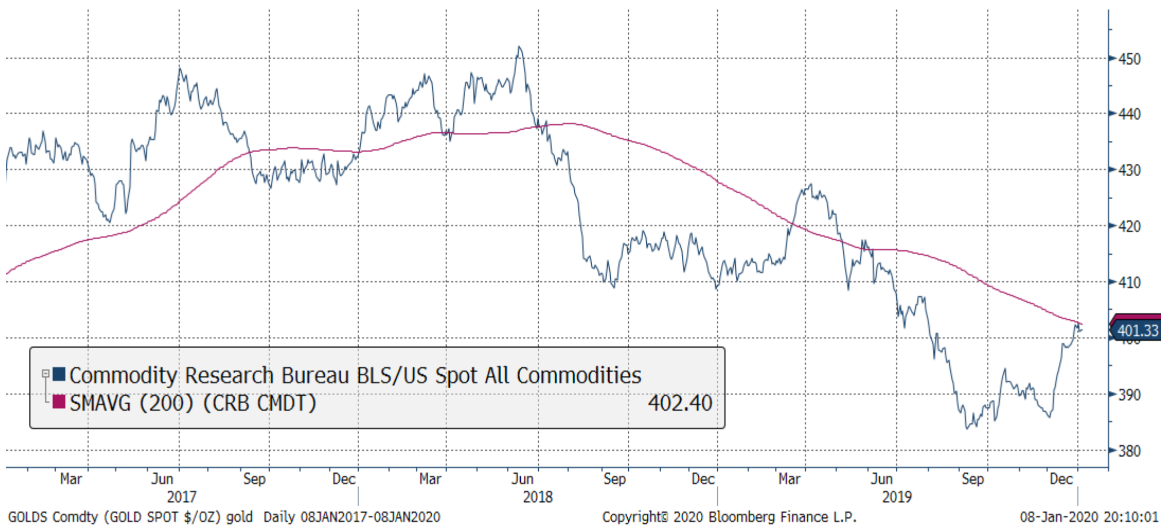
Gold

- Some pullback is to be expected as geopolitical risks subside, but I'd be concerned below $1520…

CRB Index

- So far, so good, but I'd like to see this rally continue towards $420…



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## Industrial Metals

- Not doing much – this complex needs to continue to move higher if recession fears are to be fully dismissed…

## The Dollar Index

- **The Dollar bounce is disconcerting**
- Any further rally (as little 50 bps) would elicit some profit-taking on my part

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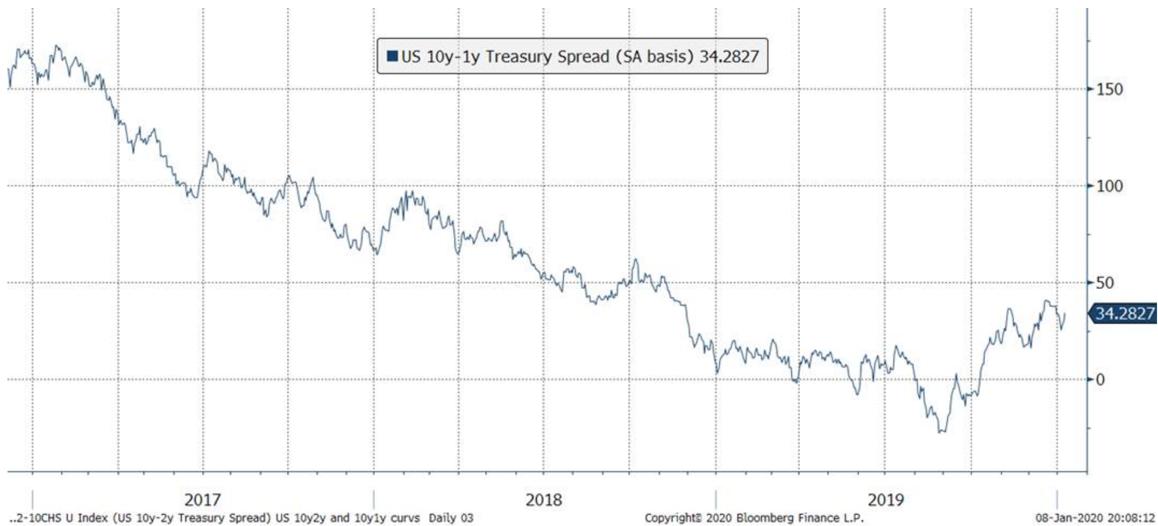
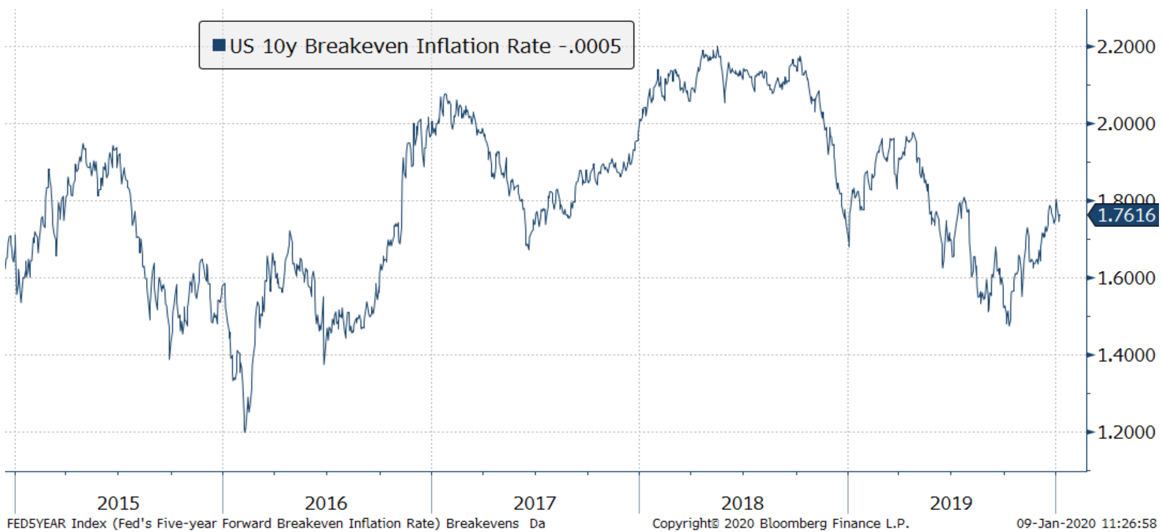
The Yield Curve (10y-1y)

- Steepening must continue to confirm the reflation trade
- Any re-flatting through +15bps would be a very bad sign for risk assets
- Bear-steeping after an inversion signal but before the onset of recession is not unusual. **The YC has by no means issued an "all clear" yet**.




10y U.S. Inflation Breakeven

- Still too low to inspire confidence that the Fed is in a mandate-consistent posture…



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