Secular reflation

Jonathan Pain | The Pain Report | 13 May 2015 |

In the spirit of "a picture paints a thousand words", Figure 1 below, of 10-year German bond yields, is one for the record books.

Figure 1: 10-year German bond yields

Source: Bloomberg

I have been more positive than most on the global economic outlook, and never could get my head around negative bond yields in Europe. When the Swiss 10-year yield traded at a mind-boggling -32 basis points on 26 January, I chose to largely ignore it, as the Swiss bond market has always been a bit weird. But, when the mighty German 10-year Bund hit an historic low yield of 0.0485% on 17 April, I stared at my Bloomberg screen in a state of shock. You see, I started in the bond markets in London in the early eighties, when the bond and currency markets ruled the world. Bond markets - and more particularly the shape of yield curves - tell you everything you need to know. They are the ultimate crystal ball, providing data and market junkies like me with the market's expectations for economic growth, inflation, monetary policy, fiscal policy and a twist of geopolitical reality too. It's not something we talk about much at BBQs, and most times we whisper furtively amongst ourselves so no one hears us talking about negative convexity and the like. And, every now and then we talk loudly about Manchester United's latest result so everyone thinks we are normal! In reality, we stare endlessly at the changing shapes of yield curves and hope that no one finds out. So, for someone like me, the 10-fold rise in German bond yields is seismic. I can't think of a stronger word.

So let me get straight to the point and say that I think we have seen the low in European bond yields and that we have commenced on the path - at long last - of reflation. There will be fits and starts along the way, as there always is, and many brilliant minds will endeavour to talk their book from their ivory towers.

I never did buy into the Larry Summers' secular stagnation view of the world, and always found it to be so very western centric, if not US centric. Every now and then, Summers needs to remember there are 7 billion people in the world, most of whom are experiencing a secular transformation which is undeniably positive - and most certainly NOT one of stagnation.

As I have been saying for some time, I sense we are seeing signs of traction between monetary policy and the real economy in both Europe and America. Furthermore, as also argued previously, the decline in oil prices allows three of the most populous countries - China, India and Indonesia - to cut interest rates. In fact, China has now cut interest rates three times in the last six months, and will cut further. They have much ammunition left in their monetary chamber and will no doubt fire off further salvos as they manage the herculean task of re-balancing their $10 trillion economy.

In so many ways, the secular stagnation thesis reminded me (in a very paradoxical way) of the technology bubble, but in reverse. In the late 1990s, the good times would never end. Today, John Mauldin, Larry Summers et al claim the bad times will never end. In a sense, it is a peculiarly American narrative and perhaps from where they sit, all they can see is a great power in decline. From where I sit, I see a great power that needs to learn to share power. I also see many nations - such as Vietnam, India, Indonesia and The Philippines, to name just a few - rising with vibrancy and purpose. Vietnam has just enjoyed the longest period of peace and prosperity in its history. I don't call that secular stagnation. I call it secular peace and prosperity.

But, as many of you know, people who are bearish and negative sound so much more intelligent than those who are bullish and positive. I sounded very clever in 2006 when talking about excessive debt and housing bubbles in America. Today, perversely, I am finding it really tough telling people how positive I am.

Talking of being positive, it's time to discuss China.

There are so many good things happening in China that it is hard to condense them into a succinct paragraph. The liberalisation of financial markets continues and we must prepare ourselves for the internationalisation of the renminbi (RMB). This will be a seismic event in the history of the global capital markets - and, yes, I know, that is the second time I have used the word seismic in this report. The simple fact and new reality is that the Chinese global footprint is growing ever larger and the Americans (and for that matter the French and the Japanese) can no longer exclude China from the corridors of power at multilateral institutions, such as the IMF, World Bank or Asian Development Bank (ADB).

It is easy to see why China is establishing the Asian Infra-structure Investment Bank (AIIB), given that China's voting rights in the ADB are less than half that of Japan. Similarly, you do not have to be Sherlock Holmes to know that China has been deliberately marginalised at the IMF, where their voting rights are smaller than those of France.

There are very few things one can predict with certainty in life, but the growing role and acceptance of the RMB is one. The other is that Chinese equities will comprise a larger share of global equity indices in the years ahead.

Last month, I sent out a tweet describing the Chinese equity market as being the least loved rally in history. I must confess that even I have been surprised and recently reduced my exposure. I still prefer H-shares to A-shares.

Returning now to the reflationary theme of this month's report - can I be so bold as to suggest that we have a world firing on all cylinders? The road to reflation will be bumpy, particularly in Europe. But, you must surely acknowledge that Europe has the best cocktail and confluence of supportive macro forces we have seen in a very long time. And yes, I know there is still the tragedy of Greece, which still makes headlines. My only contribution to this never-ending saga is that the jet-setting Greek Finance Minister, Yanis Varoufakis, helps relieve the nation's debt burden by redeeming his frequent flyer points!

Bonds are a call option on secular stagnation and deflation. Equities are a call option on reflation and prosperity.

I'm looking forward to secular reflation.

Jonathan Pain is Editor of The Pain Report, an independent and global perspective of financial markets and world economy, free of Wall Street spin. A self- confessed market and economic data junkie who spends far too many hours thinking about what the world will look like in the years ahead, JP is a regular key note presenter at PortfolioConstruction Forum's professional development programs. Over the years, he has debuted new investment theses and challenged delegates about how to build better quality investor portfolios.

More about Jonathan
