DrobnyGlobal

Drobny Global Monitor

December 1, 2016

www.drobny.com andres@drobny.com 202-210-4456

Biases:

EQUITIES: ****Formerly Bearish***
BONDS: Bearish; Bullish Bond Vol; Curve Steepeners
FX:

Current Exposure:

EQUITIES: Short Bovespa (Nov 10);
BONDS: Short UK 30yr TIP (Oct 25);
Short 10yr US Treasury (Sept 26);
Receive 2yr Japan swap (Sept 26);
FX: Long USD vs SFr (Nov 14);
Long USD vs HKD (July 18);
COMD:

The End of the Deflationary Era

**** Please note latest changes to biases and/or exposure***

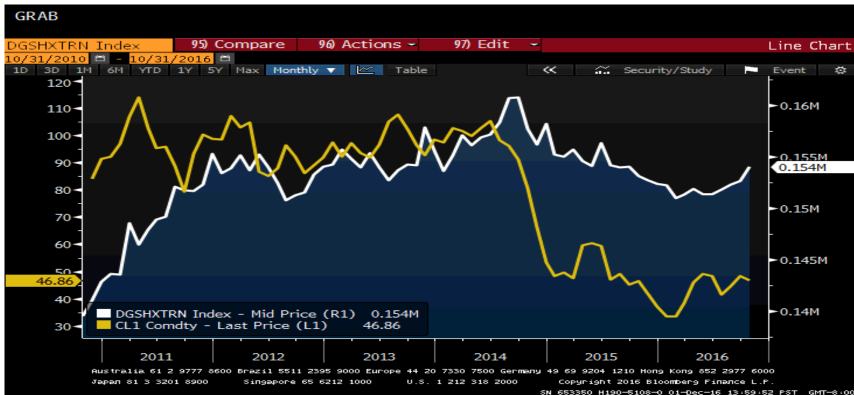
There's a sense that the deflationary era may well be coming to an end. This is in part due to the enhanced prospect of fiscal stimulus in the US and the potential for a good burst of short term growth. But, it is also about the longer term impact of changing directions on globalization. The former seems more straight forward and better understood; the latter perhaps takes a bit longer to fully appreciate, at least for some (guilty!).

But, first short term growth. The leak today that the ECB may signal an intention to start a tapering process at some point next year fits the concept that deflationary pressures may well be abating. So, too, does the buoyancy of some commodities despite the USD rally.

And, behind much of this is a sense that a genuine global growth rebound is emerging, which will get an additional boost from a global shift towards fiscal stimulus. Including in the US, where the end of gridlock, at least for now, opens the door to significant fiscal stimulus next year.

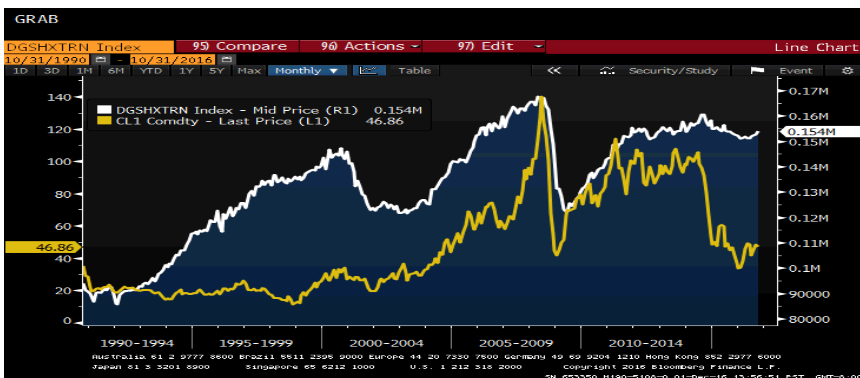
The factors behind the growth rebound can be seen in the picture overleaf, which shows the level of US durable goods shipments (excluding transport) and the WTI oil price over the past few years. US durable goods shipments give a decent sense of where investment spending in the economy is going. As the picture shows, it was on a decent growth path up through 2014.

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.



But, the turn in the USD and the resulting sharp drop in commodity prices led to a drop in energy sector investments, pulling down US growth for a protracted period. The bottoming and, more importantly, the stabilization of oil prices reduced default risk in the energy sector. And, soon after, durable goods shipments have been on the rise again, indicating that investment spending is once again on the rise. That seems to be giving a boost to US economy and could well be a factor more globally. This is all before Trump.

But, now look at the same picture from a longer term perspective (below). The recent developments look puny in comparison to the past. The US investment booms that took place in the mid-late 90s and from 2003-2007 tell us how far the US has to go here. And, with investment spending already on the rebound, fiscal stimulus can really goose growth and perhaps quickly.



Notice one more thing. The drop in oil and commodity prices in 2014 was exceptionally severe. Hence the dislocations that emerged in commodity producing sectors. We start today with commodity prices much lower. This means any USD rally that accompanies US fiscal stimulus and faster US growth may well prove less disruptive to global growth than in the recent past.

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.

That is, a further USD rally makes it more likely that the US exports inflationary pressures abroad as US growth strengthens on the back of fiscal stimulus. That's very different from the 2014/2015 USD rally which was associated with rising deflationary dangers. That USD rally generated fears of FED overkill and of a collapse in commodity prices and commodity production. That doesn't seem as relevant today.

Now, one exception to this, and an important one, is if a trade war emerges. If the US introduces tariffs on foreign produced goods, then this reduces the extent to which the US exports reflation and instead keeps the bulk of the stimulus benefit within the domestic US economy. This would create a relative growth story, and argues for another episode of US equity outperformance relative to EM.

But, in circumstances of US stimulus, the imposition of tariffs would likely prove inflationary rather than, as in the early 1930s, it proved deflationary. The initial introduction of tariffs in the Great Depression took place within the context of policy tightening and falling global growth. In this instance, it would take place amidst fiscal easing and strengthening growth.

So, even if fiscal stimulus is married with a tariff policy in the US, so that the stimulus is absorbed mostly at home, it is more likely to result in inflationary pressures rather than deflationary pressures. Unlike the 1930s analogue. This forms the basis for the idea that the most robust Trump trade is buying US BE inflation. Unlike with equities, it should be robust even with the imposition of tariffs.

So, shorter term there are reasons to feel relief that the deflationary menace has been thwarted. But, there is a potentially a bigger issue at play which relates to globalization itself.

Start with a picture of global and US inflation over a long period (below). Now, the numbers in the picture are big, so that the difference between global inflation in, say, the late 1990s (top line) don't look so different than inflation today. Yet, they were running at 5% plus in those days and only ½ that today. And, inflation was running a good deal higher in the 1980s and earlier in the 1990's (and

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.

presumably the big spikes in the global inflation figure represents significant devaluations in some important countries). But, we've certainly seen a trend down in inflation since the 1980s.

There are many reasons for this, of course. Technological advance, the introduction of inflation targeting by central banks, etc. But, globalization and especially the accelerated trade deals of the past 20yrs could well be a big factor. And, perhaps bigger than some of us appreciated.

This goes back to an argument made at the Santa Monica Conference at some point in the mid 2000's. It was suggested that the notion of convergence between EM and DM was a new reality and a departure from historical patterns. This idea was a surprise to many of us in attendance, but was explained in terms of countries that industrialize first tended to depart from the pack. This would create divergence. It suggests that something unusual with broad relative growth patterns has been going on over the past 20-30yrs.

And, consider the picture below, which shows a measure of EM growth vs US GDP growth. This is a very crude way of demonstrating the point: it's really only recently that EM countries as a pack grew faster than the US. And, it is likely misleading, since this particular data doesn't go back to the 1980s and early 90s when the Asian tigers were growing at massive rates. But, it is interesting and instructive to consider that during the 2003-period when EM growth surpassed US growth on this measure, global inflation rates halved. And, this all occurred during both a boom and bust in commodity prices, so that is unlikely to be the factor.

So, why this unusual occurrence, where EM growth has surpassed DM in a sustained fashion? An interesting and in vogue answer is globalization and those trade deals.

What did the trade deals offer? In terms of economics, they seem to have offered EM countries, from China to Mexico, more open markets to exploit their low cost advantages. And, their export share has risen through this period.

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.

Faster EM growth also meant that DM exporters had more consumers to sell goods to. And, another gain was not just in terms of a widening choice of products available for DM consumers, but also products available at a lower cost. During the era of globalization and free trade deals, prices of a wide swath of manufactured products from clothes to TV's, etc, became cheaper as global manufacturing production shifted from higher cost DM countries to lower cost EM countries.

That seems to have been the main bargain in these free trade deals. And it offers an explanation for the observation that this unusual period of EM/DM growth convergence was associated with a period of declining global inflation rates. And, a growing threat of a deflation menace.

Now, obviously, this is not a complete explanation of the forces at work over the past 20-30 years. As mentioned earlier, there are many other changes that have taken place during this period.

But, it also points to something Trump (and Democrats) failed to address about his protectionist plans: tariffs and other protectionist measures may well produce more domestic jobs, but at the cost of consumers likely having to face higher prices.

More importantly, a turn in the inflation trend doesn't require the imposition of tariffs or a breakdown in global trade. The mere slowing of globalization trends and the ending of a shift of production to low cost EM countries should be enough.

And, this also explains the global impulse against globalization trends across many DM countries. The burdens of the process became harder to tolerate post 2008 while the benefits in the form of lower prices became not just less attractive, but actually became part of the deflation problem!

There are several implications of all this, and not just for BE inflation or the interest rate outlook. As mentioned earlier, it adds to the case for DM equity market outperformance, as relative growth rates shift away from EM. And, in an environment of accelerating US growth, a USD rally may no longer be so associated with market turmoil and turbulence, as deflationary pressures generally abate. Recent correlations, such as the association of USD rallies with turbulence and violence in equity markets, may no longer hold if the underlying inflation trend has changed.

More importantly, if the era of deflation is really coming to an end, then the tail risk for equities will be substantially reduced. This is not about policy or taxes or the growth outlook per se. Rather, when inflation is trending upwards rather than downwards, the real value of equities can go down without nominal values going down much.

That's what happened in the 1970s as inflation accelerated. During a trend bear market in bonds and tremendous volatility in equities, nominal equities actually ended the decade roughly unchanged (US

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.

Dow Jones, below). This occurred despite a substantial trend rise through the decade in real rates and commodity prices. And, a drop in the real value of equities of maybe 50%.

Now, equities were hardly the best investment during that decade, though they did outperform bonds. That's not the point. And, this is not to argue that we are entering an era akin to the stagflationary 1970s.

Instead, the point is much simpler: in an environment of rising inflation, nominal equities have less of a hurdle to overcome to post gains compared with times when inflation is low and outright deflation is a threat. Instead of relying on more efficiency gains, companies instead get more pricing power. And, interest rate hikes are less of a burden when inflation is rising, except when rates are hiked aggressively above the inflation rate which in turn raises real rates considerably.

A lot of things can change if the era of deflation is truly coming to an end. And, short and longer term factors seem to be pointing in that direction….finally.

Andres Drobny

Past reports can be accessed at www.drobny.com

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.

Drobny Global Advisors, LP is an independent research firm. This report is provided solely for informational purposes. It is not intended as an offer to buy or sell any instrument or security nor as advice or recommendation to participate in any particular trade or trading or investment strategy. The content of this report is based on or derived from information generally available to the public from sources believed to be reliable. No representation or warranty, express or implied, is made as to the accuracy or completeness of such information. Past performance is not an indication or guarantee of future performance and no representation is made regarding future performance. Opinions expressed in this report may be changed without notice and may be inconsistent with, and reach different conclusions from, prior or subsequent reports. This report may not be reproduced or redistributed to any other person, in whole or in part, without prior written consent from Drobny Global Advisors, LP.

This report does not consider the specific investment objectives, financial situation, or particular needs of any specific person, fund or institution. Accordingly, recipients bear responsibility for their own investment research and decisions and should seek the advice of qualified advisors, and perform their own due diligence, before making any investment. From time to time, Drobny employees may trade for their own accounts in markets covered by the Drobny Global Monitor. Additionally, guest research pieces written by outside parties may describe trades, trading strategies or investment products in which the authors or their firms have or intend to acquire positions.

Copyright © 2016 Drobny Global Advisors L.P.
No reproduction, transmission, or distribution permitted without the consent of the copyright holder.