What’s to be made of the “Trump reflation trade”?

- In the weeks following the November election, stock and bond markets both predicted boosts in growth and inflation – i.e., the “Trump reflation trade.”

- But after December, long-term bond yields began to fluctuate, reflecting doubt about the reflation trade, while stocks plowed ahead undeterred.

- The Fed is likely to remain on course raising short-term rates, but long-term rates are unlikely to break out on the upside, resulting in a flattening yield curve.

- We believe the bond market’s cautious view of the Trump reflation trade is more appropriate than the stock market’s enthusiasm, given today’s relatively high level of uncertainty.
Investors had the “Trump reflation trade” on their mind in the first quarter of 2017. But while the stock and bond markets were generally of one mind about the trade until mid-December, they were of two minds by the time the first quarter ended. Stocks maintained their enthusiasm, while doubt crept in on the fixed-income side. This quarter we’ll look at what that “split decision” might mean.

In the wake of the election, both stock and bond investors embraced the idea that pro-growth policies of the Trump administration would further boost inflation. The S&P 500 added 4.6% between the election and 31 December, while prices fell on 10-year U.S. Treasurys as yields rose by more than 50 basis points and finished the year over 2.4% (Exhibit A). The Bloomberg Barclays U.S. Aggregate Index, a broader measure of the bond market, also lost ground over that period.

The postelection divergence of stock and bond prices represented a classic reaction to the prospect of stronger growth. This contrasts with most of the prior postfinancial crisis period, when central bank liquidity kept a lid on interest rates, which supported prices of both stocks and bonds. The divergence continued until 15 December, after which bond yields came back in and prices again rose along with stocks. Since mid-December,

The case for a flattening curve

Taking a closer look at the forces driving the bond market, it’s clear that the controlled nature of the short end of the yield curve contrasts significantly with the more market-driven long end. At the short end, the main driver – the U.S. Federal Reserve’s plans to boost short-term rates – remains in place.

Exhibit B shows that the latest reading of the Fed’s favoured inflation gauge – core personal consumption expenditures (PCE) – is close to its 2% target, and just modestly below inflation expectations, as shown by 10-year TIPS break-even rates. In prior years, expectations had been running well ahead of actual inflation, but that gap has narrowed. Unemployment has also declined to reach the Fed’s target.

With the convergence of actual inflation and inflation expectations, the rate forecasts of the market and the Fed
have also come together, for the first time in years. Exhibit C shows that as recently as last September, the Fed’s expectations for rate hikes were significantly more aggressive than the market’s, as measured by forward three-month rates. By March, however, the two sets of views were substantially aligned.

**A rise in real rates**

Exhibit D shows 10-year U.S. Treasurys vs. 10-year TIPS breakeven rates. In the absence of significant quantitative easing in the U.S. (except reinvestment of the Fed’s portfolio cash flows), the long end of the yield curve is now largely determined by market forces. One of the interesting developments since the election has been how the market has pushed up real yields: Nominal long-term rates jumped, while inflation expectations, after a spike in January to around 2%, have moved sideways. The difference in the two components is the real rate, which was about 50 basis points (bps) at the end of the quarter.

The increase in real rates might be seen as the bond market buying into the Trump reflation trade. But the recent seesaw pattern of nominal yields (Exhibit A), while inflation expectations (as measured by the TIPS break-even rate) remained steady, indicates a lack of...
strong conviction.

This lack of conviction is understandable. The deflation/weak global growth scenario was prevalent until recently, and there is plenty of uncertainty around Trump's protectionist tendencies to keep that possibility alive in investors' minds. Moreover, low yields remain pervasive in developed markets, as a result of anti-deflation policies of central banks. Strong demand from global investors continues to keep those yields low, and counterbalances the upward forces on 10-year U.S. Treasuries.

As a result, we do not see a strong likelihood of an upside "breakout" of 10-year Treasury yields, while the short end is likely to rise, resulting in a flattening yield curve scenario as the most likely over the balance of the year. This would favour strategies like floating-rate loans and other short-duration strategies, whose yields would likely increase along with the expected increases in the fed funds rate.

A (differing) tale of two markets

Returning to our original observation, if the stock and bond markets are each saying something different about the Trump reflation trade, which one should be believed?

The bond market's equivocation is recognition that plenty can go wrong with the growth scenario, while the stock market is partying like it's 1999. The stock market may be considered expensive using a number of valuation measures, such as the price-to-sales (P/S) ratio. Exhibit E shows that when the ratio has reached the the level of 2, as it stood at quarter end, historically it has been followed by 10 years in which the average annual total return has been flat or negative (looking at rolling 10-year periods between 1973 and 2006). In contrast, when P/S ratios have been at 0.50, as they were, for example, in September 1984, the annual total return of stocks over the subsequent 10 years was, on average, 15%.

Obviously, times and circumstances change and an historical 10-year subsequent average return is merely that. However, it is fair to say that at current levels, the stock market has pinned its hopes on the overwhelming success of the Trump reflation trade. It's good to recall the words of American novelist William Faulkner: “The past is never dead. It's not even past.” Right now, the bond market seems to understand that better than the stock market.
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