

Call Me An Old Curmudgeon

Charles Gave

cgave@gavekal.com

The Wicksellian spread indicates that things could be about to get "interesting"

Call me an old curmudgeon, but financial markets are currently experiencing an outbreak of optimism that could well prove to be dangerous. At the moment we have a situation where both the US stock market *and* long rates are rising on expectations of faster nominal growth. Readers who have followed my Wicksellian research are no doubt scratching their heads over this concurrent move, because they will appreciate that there is no prospect of inflation in the US economy. As a result, it is to be hoped that the markets are right, and that real growth does indeed pick up as the moves in asset prices imply, because if not, markets may be approaching a very interesting turning point indeed.

To explain why, it is first necessary to offer a very brief recapitulation of the Wicksellian spread, and what it signals (for a full explication please see my latest book *Stagnation Or Bust?*). Any Wicksellian analysis starts with the difference between the market interest rate and the natural interest rate. The market rate I use is the *real* rate on long-dated seasoned industrial bonds, which I arrive at by deflating the nominal yield on Baa-rated bonds by the seven-year moving average of US CPI inflation. And as a reliable proxy for the natural rate, I simply take the real year-on-year growth rate of US gross domestic product. The difference between the two is the Wicksellian spread, which is depicted by the area shaded red in the chart overleaf.

At any one time this Wicksellian spread can fall into three zones, each of which has different implications for the economy and financial markets:

1) When the market rate is way below the natural rate, with the Wicksellian spread at zero or above on the chart overleaf. Periods when this happens are always followed within a few quarters by an acceleration in the rate of CPI inflation, as in the late 1970s.

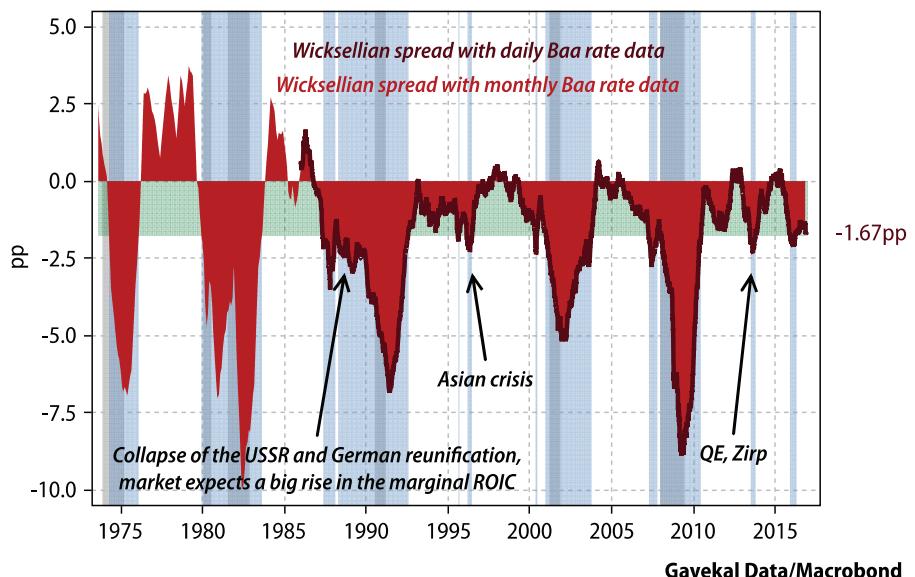
Checking The Boxes

Our short take on the latest news

| Fact | Consensus belief | Our reaction |
|--|--|--|
| US NFIB small business optimism rose to 98.4 in Nov, from 94.9 in Oct | Much higher than 96.7 expected; highest reading since Dec 2014 | Positive data; job openings & hiring plan components moved away from recessionary territory |
| German ZEW financial market survey expectations 13.8 in Dec, unchanged from Nov | Below 14.0 expected; survey on current situation rose to 63.5, from 58.8 | 4Q GDP to strengthen; after 12m soft patch, foreign demand picking up & bolstering growth |
| UK CPI rose 1.2% YoY in Nov, from 0.9% in Oct | Above 1.1% exp.; highest since Oct 2014; core CPI rose 1.4% YoY, from 1.2% | Price pressures building esp. in non-food categories; energy & GBP main causes for inflation |
| Japan Tankan Large Mfg index rose to 10 in Q4, up from 6 in 3Q; other sub-indexes also rose | As expected; however expectations for capex growth slowed mildly | A weak JPY & improving global demand help; Japan is still a good global reflation trade |

The Wicksellian Spread is bordering on the danger zone

When the spread is below -1.75pp (shaded blue) the risk of financial crisis and recession is high



All recent bear markets in equities have been signaled in advance by the Wicksellian spread indicator...

...which is now bordering on the danger zone

2) When the market rate is above the natural rate by less than 175bp, with the red line in the green band on the chart above. This signals a deflationary boom scenario, in which investors should own long duration financial assets with a preference for equities.

3) When the market rate is above the natural rate by more than 175bp. These periods, shown by the areas shaded blue in the chart above, are when the risk of financial accidents is highest. Every recent US bear market (defined as the S&P 500 down by -20% or more YoY) occurred during one of these periods. Such a bear market may or may not be followed by a recession, but each recent US recession occurred in one of these periods.

So, with the Wicksellian spread currently at -167bp, just a few basis points from the border of the danger zone, things are getting interesting. The last time the spread passed the trigger point was almost exactly a year ago, and within a matter of weeks, the S&P500 had fallen -12%. Then rates began to decline, with the Baa rate falling from 5.5% to 4.2% by mid-2016, which brought the Wicksellian spread back into the safe space. Nevertheless, from November 2015 to June 2016, long-dated treasuries massively outperformed the stock market. Since July, with the spread in the safe zone, equities have outperformed.

Where does this leave us now?

- Let me be clear: there is absolutely no inflation risk in the US economy. The cost of funds for the private sector is far too high.
- The steep sell-off in long-dated bonds has brought yields back to levels where in the past investors should have started to increase the duration of their portfolios (see [Prospects For The US Bond Market](#)).

- As far as equities are concerned, the market is skating on very thin ice. Any further rise in rates relative to the 50bp increase in fourth quarter YoY GDP growth expected because of the base effect could lead to steep falls in a stock market where the average share is heavily overvalued by historical standards (even though the capitalization-weighted index does not look particularly overvalued).

Investors should shift to a balanced portfolio allocation

We could be about to enter into a very dangerous period indeed. As a consequence, I repeat the call I made last month, in which I advised investors managing money in the US to shift their allocations back to a classic balanced portfolio of 50% long bonds, 50% equities.

Of course, it is possible that yields could start to decline from here, much as they declined after the mysterious “Shanghai agreement” (see [Forget Central Banks, Watch Foreign Exchange Volatility](#)). But if the Shanghai agreement was largely aimed at smoothing the way for a Hillary Clinton election victory, it clearly failed. And it does not exactly look as if Donald Trump’s presidency is going to be any great respecter of informal international agreements. Hence, perhaps, the recent rise in the US dollar. And hence it would appear there is less chance than last year of a calming decline in corporate bond yields. As I say, things could be about to get interesting.