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Reflation trade comes to an end

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The markets were consolidating in March. The global equity index, the spreads for credit risk, and the yields of risk-free government bonds have been going sideways. Before that, the risky asset classes had recorded remarkable price increases, while risk-free bonds had incurred losses. Has the so-called reflation trade, i.e. the positioning towards rising nominal economic growth, come to an end?

Recovery

The bigger picture: the recovery from the Great Depression some ten years ago has been completed in more and more countries. In fact, the USA and Germany are already transitioning to the next economic phase, i.e. the boom phase. Inflation is currently in a favourable bandwidth: the spectre of falling wages and prices has disappeared; inflation problems are nowhere in sight. In line with this scenario, the important central banks have cautiously reduced their monetary support. Possible disruptions for the markets could come from the political front. Generally speaking therefore, the environment remains supportive to risky assets, with the downside risks originating largely in politics.

Acceleration...

In mid-2016 the recovery stepped up its pace. Global nominal economic growth, i.e. real growth plus inflation, has increased since then. The most important reasons for this development are

1. the **stimulus measures in China**
2. the **end of fiscal austerity**
3. the **loosening of the financial conditions**.

The stimulus measures in China have contributed to a situation where the commodity prices have stabilised after the slumps over the previous years and where the global deflation pressure has disappeared. In line with this scenario, the growth rate of industrial production and of capex in the corporate sector has increased. The end of the reduction of budget deficits in the industrialised economies has been supportive to economic growth. Also, the extremely expansive monetary policies have brought about more favourable costs of capital (decline in interest rates and yields).

...coming to an end

Meanwhile the signs of an end of the acceleration phase have become more pronounced:

- The global purchasing managers index has improved significantly in the recent twelve months. However, in the year to date it has been moving sideways. This suggests that the acceleration of the growth rate of industrial production has come to an end.
- Inflation has increased significantly on a year-on-year basis. This is due to the stabilisation of the commodity prices, which has led to an increase in the year-on-year change of energy prices. However, this base effect is a temporary phenomenon. After adjustment for the fluctuating energy prices, inflation turns out to be moving sideways. Also, month-on-month price changes have been on a decline. In short terms: the rate of inflation will not be rising significantly anymore this year.
- The surprise indices for economic and inflation data stopped increasing at the beginning of the year.
- The central banks are cautiously reducing their extreme monetary support. The most recent minutes of the FOMC meeting of the US Fed also suggested an end to the re-investment of expiring bonds and coupon payments by the end of this year. The effect of a shrinking central bank balance sheet would be similar to an increase of the Fed funds rate. This means that this year we could see three interest rate hikes and the reduction of liquidity, i.e. four tightening actions.
- The rising interest rates in China have caused the monetary conditions (i.e. an index consisting of interest rate level, exchange rate, and credit growth) to tighten. This effect has been deliberately caused by Chinese politics in order to prevent the property market from overheating. However, this is detrimental to the positive impulse from China for global economic growth.

- The terms of trade, i.e. the difference between export and import prices, have stopped rising in some commodity-producing countries such as Australia, or are indeed falling, for example in Brazil.
- The inflation risk premiums implied by the bond market have stopped rising (USA) or are even falling (Eurozone).
- The yield differential between government bonds with long and short maturities has been shrinking in the USA and in the Eurozone. However, an increase in acceleration of growth while central banks are acting cautiously would imply an increase in the yield differential.

From reflation to carry

The three impulses (China, fiscal policies, central banks), that have caused growth to accelerate, are levelling off. The economic environment suggests that economic growth is now self-supporting enough for the higher level of growth to be sustainable. The environment remains positive for risky asset classes, because the economic recovery phase remains firm. But the reflation trade (accelerated growth) has come to an end for now. The investment focus is on bonds with higher promised yields such as emerging markets corporate bonds (carry). The imminent presidential elections in France have come to the fore as tangible risk.

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