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Your eyes and ears on the markets

December 10th 2021

TAYLOR RULE

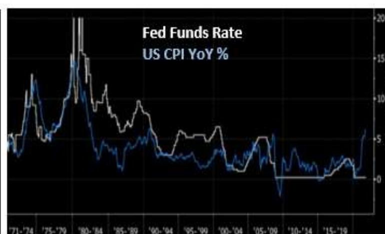
It is inherent in human nature, and the financial industry is always full of illusions, denials and wishful thinking. However, most consensuses (whether positive or negative) turn out to be wrong, as has been the case since last May (inflation, revenge spending, GDP growth, China & EM, Fed, etc).

And we believe it will happen again when **investors expect real interest rates to remain negative for years (!) + Powell's 4th pivot would not be the last one (with the Fed Chair expected to drop his hawkish stance along the way) + inflation will get back to the 2% Fed target in 2H22 + FY22 roadmap is clear, with a risk-on phase in 1H followed by a risk-off setback in 2H**.

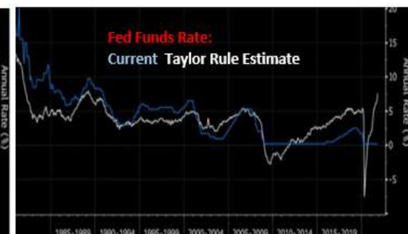
In the end, if only based on the last series of Fed dot-plots, and as priced by the markets, Fed funds will not exceed 1.5% to 1.75% (hence the yield curve flattening, etc). Needless to describe the collapse that Wall Street will be subject to, if such consensual views/expectations were wrong-footed (following a much more pronounced Fed tightening cycle); as we suspect/fear.

FED HIKE EXPECTATIONS + FED FUNDS RATE vs US CPI + FED TAYLOR RULE ESTIMATE
+ US LIQUIDITY EXPANSION + CENBANKS NET LIQUIDITY INJECTIONS & TOTAL ASSETS
+ EM & DM GVT DEBT SERVICING + US UNEMPLOYMENT & QUITS RATE & REAL COST INDEX
+ SUPPLY CHAIN DISRUPTION EXPECTATIONS

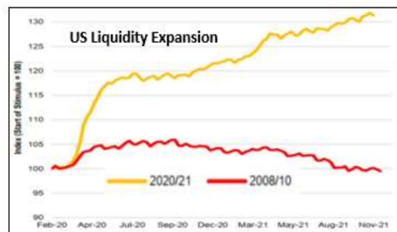
Source WSJ - **chart 1**



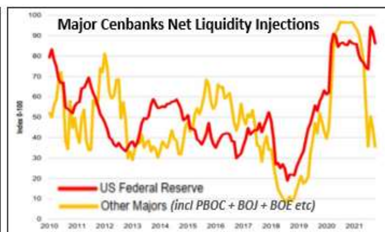
Source Bloomberg - **chart 2**



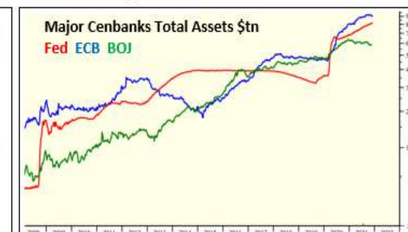
Source Bloomberg - **chart 3**



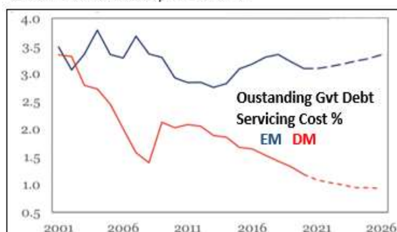
Source CrossBorder Capital - **chart 4**



Source CrossBorder Capital - **chart 5**

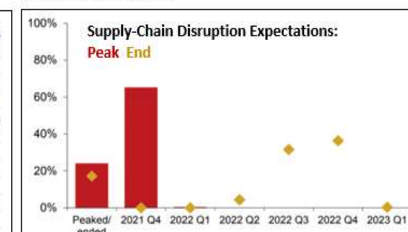


Source Yardeni - **chart 6**



Source Haver - **chart 7**

Source Deutsche Bank - **chart 8**



Source Oxford Economics - **chart 9**

The estimated date of the Fed's first hike has been steadily brought forward (chart 1), with tapering expected to be over as early as March and the funds rate ultimately reaching 1.5% to 1.75% (based among others on the Eurodollar strip). However, even though the real Fed funds rate has often been negative since 2003, it was the other way round during previous periods of more sustained inflation (ie from 1980 to 2002) whereas all hiking cycles have always ended in significant positive territory (for the real Fed funds rate - chart 2).

Moreover, based on the Fed Taylor Rule (such that rates should be raised when inflation is above target + GDP is above potential), Fed funds should be much higher today (chart 3), suggesting that the US cenbank is dramatically behind the curve.

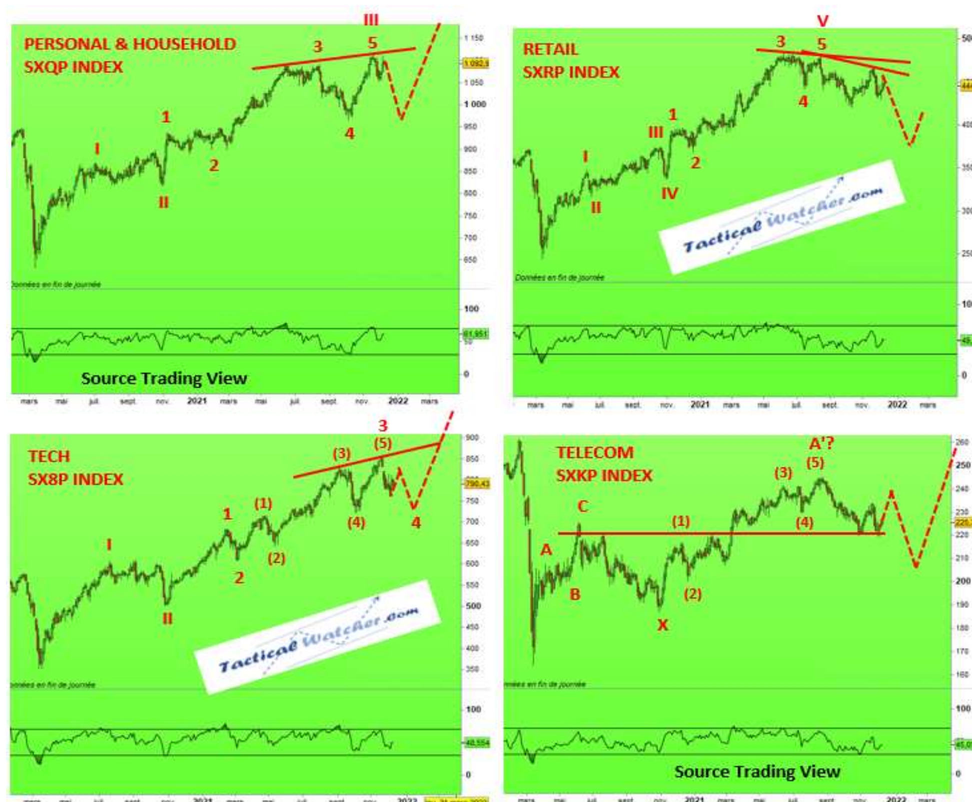
No need also to remind how excessive/exceptional the liquidity expansion has been since the pandemic (chart 4), while it is no longer relevant/useful (not to say that it is counterproductive and insane now). Worse, although comparisons should be made relative to the GDP (chart 5 + 6), we can't be surprised to see that **the stock markets which have suffered since 1Q21 are those in the regions that have reduced their monetary stimulus (China, Japan, EM), while Europe + the US have continued to perform in conjunction with the ECB/BOE/Fed balance sheets.** The fact that the interest burden is now rising in EM (as a result) is not a surprise either (chart 7).

In this context, all eyes will be on the US CPI this afternoon and, above all, the FOMC next week. Investors who actually expect the situation to improve soon are missing the point that shelter inflation and labour tightness (suggesting that full employment has been reached while the Phillips curve is back on – chart 8) will easily offset the recent relapse of oil & Nat Gas (not to mention, among so many examples, NY City rents rising by 22.8% YoY + online inflation up 3.5% in November, with apparel prices jumping 17.3% YoY + etc).

The Fed is data dependent, and we fear that more hawkish-than-expected dot-plots next week may lead to a sudden and negative repricing of the markets, despite the consensual expectation of the end of supply-chain disruptions in 2H22 (chart 9).

STOXX 600 SECTORS SCANNING

Every day, 4 of the 16 main sectors of the Stoxx 600 are reviewed graphically on daily charts. Attention is particularly attracted when 9-demark signals are flashing and clear opportunities/patterns arise.



EUROSTOXX FUT – DAILY

We like what we see so far, but we need more however, with the break of the key support to confirm that the decline since the top of wave III is definitively resuming. Valid especially as long as the key resistance holds.

HANG-SENG FUT – DAILY

The bottom of wave (1) within the decline developed since the end of wave 4 is under pressure. To develop a last downleg, a reversal would be welcome now on the downside. Otherwise, we will come rapidly to the conclusion that the overall decline since last February is over (then following a textbook truncated wave 5).

Ps: the picture is similar on the Hang-Seng Tech index.

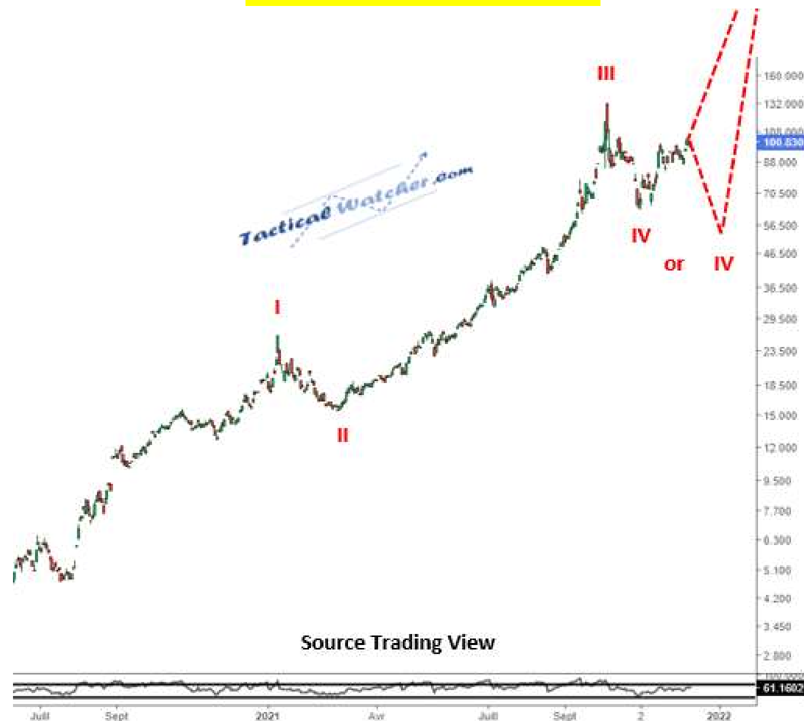
MSCI EM – DAILY

Somewhat, the situation is similar on the MSCI EM. As the low of wave (1) within the decline developed since the top of wave X is under pressure, a reversal should/must occur now on the downside to retain a negative bias (?).

RUSSELL 2000 FUT – DAILY

We would rather expect wave 2 or B to last longer for the moment. Possible as long as the series of support levels mentioned above hold.

DUTCH NAT GAS FUT – DAILY



We stick to our wave V scenario on the upside, especially on the European Nat Gas, and we will get back to it fundamentally next week (with the implication/risk of Ukraine/Putin/Nato/Biden + Nord Stream 2 pipeline + low inventories + etc).

US 5-YEAR BREAKEVEN INFLATION RATE – WEEKLY

We always try to remain as objective as possible, and we must admit that graphically the rally since March 2020 on the breakeven rate above could be over. Two things however come to our minds:

1) **(as often mentioned) can we trust the US yield curve as long as the bull is (still) in the china shop?**
2) **Inflation levels around 2.50% would still open the door to a 10-year yield of circa 3%, with the repricing that would follow on Wall Street + higher debt servicing + end of TINA + unwinding of leveraged positioning + etc.**

US 10-YEAR BREAKEVEN INFLATION RATE – MONTHLY

In the same regard, the 10-year breakeven rate has been unable (at least so far) to overtake the series of highs that has capped any advance over the past 15 years.

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