Politics, positioning and inflation

08 July 2024

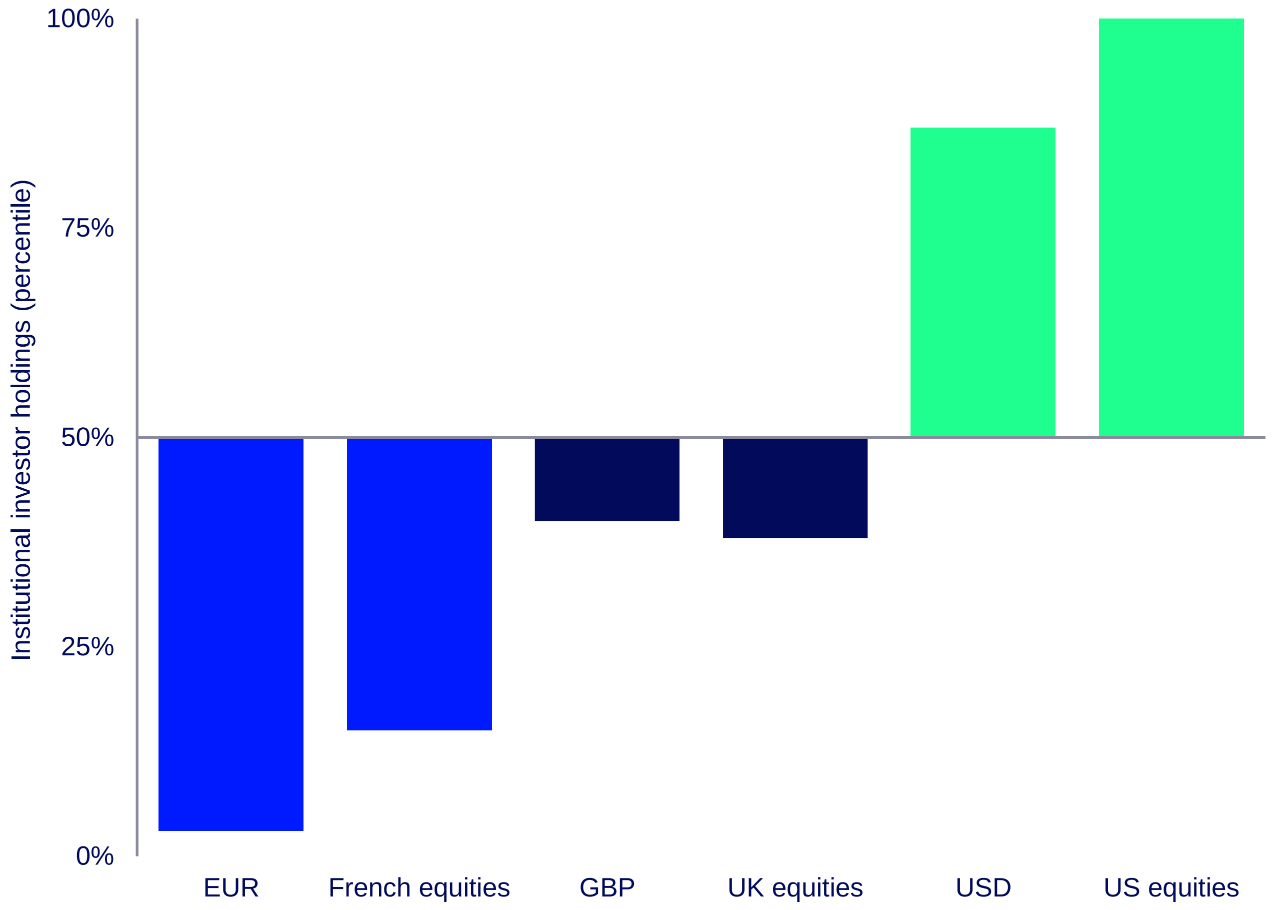
Political positioning, from pessimism to optimism

In light of the current dominance of political news, it is noticeable how differently long-term investors are positioned.

Pessimism on the EUR remains and investors have quickly moved to an underweight in French equities too.

In the UK, investors have been more sanguine. Squaring their short in GBP and remaining neutral on UK equities.

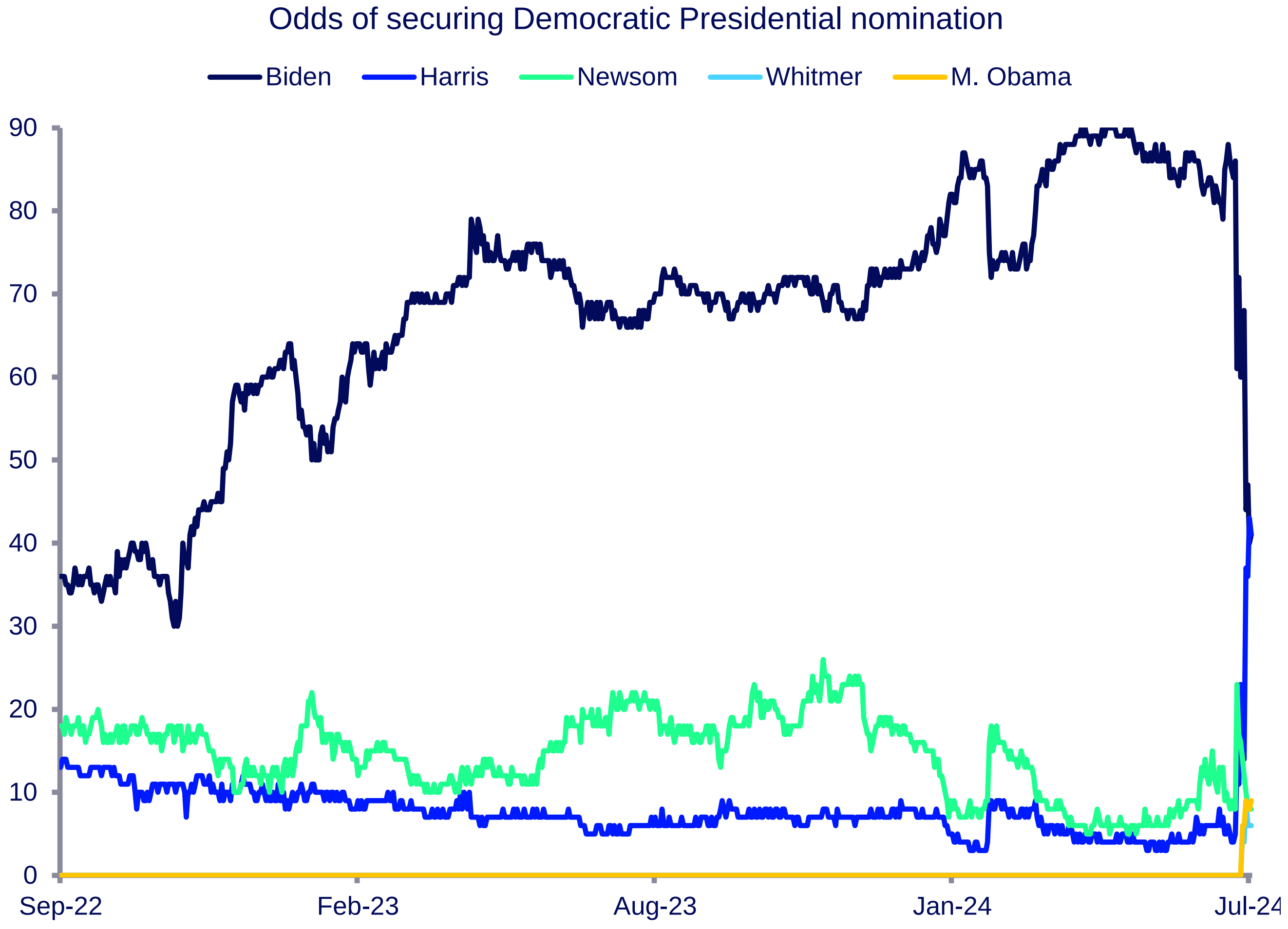
While investors remain optimistic on US assets, in both the US dollar and US equities, although how much of this reflected relative fundamentals rather than politics is debatable.



Source: State Street Global Markets, data as of 2nd July 2024

Harris the chosen one?

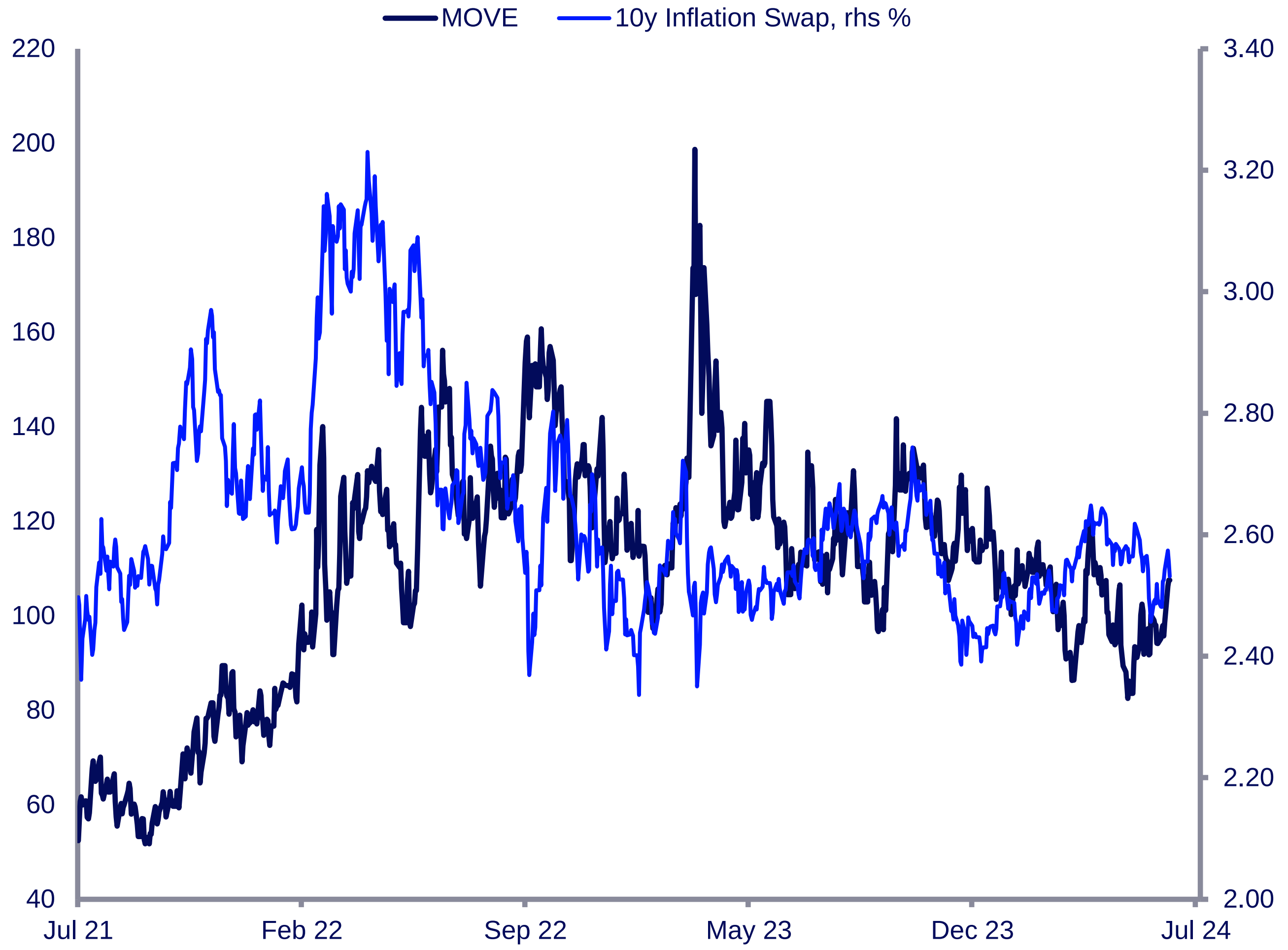
Following the disastrous debate for President Biden just over a week ago, speculation over whether he will remain in the race is rife. According to betting markets, VP Harris is the clear favourite to step up if President Biden decides not to run. PredictIt has the odds of her securing the Democratic nomination at 41% now, equal with that of President Biden. Of the others, Governor Newsom is on 8%. Michelle Obama meanwhile is at 9% and Michigan Governor Whitmer at 6%. It seems that the most likely way that VP Harris would gain the nomination is if President Biden gifts his electoral votes to her. However, it is possible there is an open convention where any other candidate can run. Watch this, very movable, space.



Source: State Street Global Markets, Bloomberg, PredictIt

The Trump II Variables to Watch

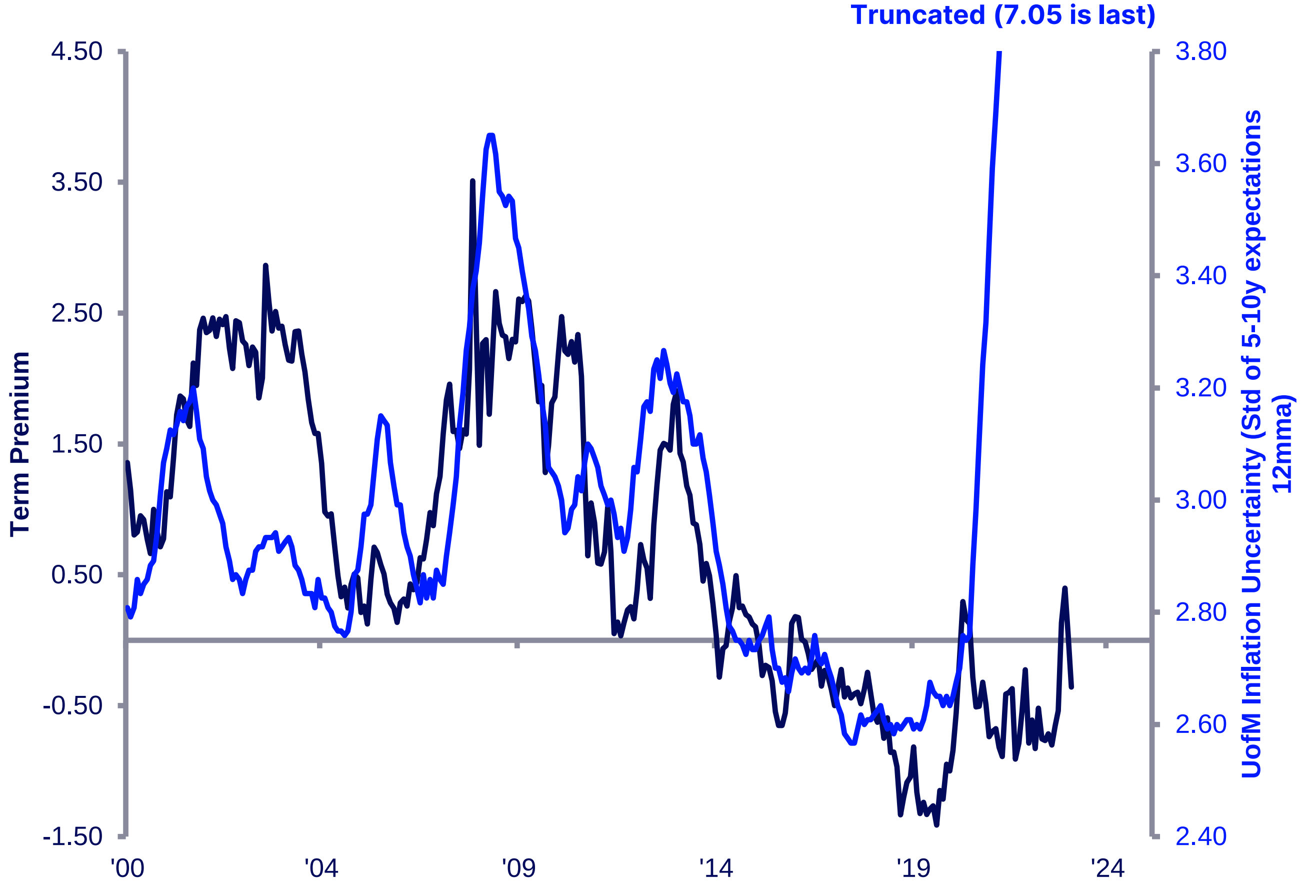
Following last week's Presidential debate, the likely winning trades were Donald Trump to win a second term came into view – US rates and breakevens rose, curves bearishly steepened. Trump's policy aims are seen as inflationary. The pertinent questions for markets are: 1) Will be deliver? and 2) What would the Fed do about it? For the latter answer, look to inflation expectations. The risk of de-anchoring post COVID was stopped by an aggressive Fed hiking cycle. A discontinuous rise back to the 2022 highs would surely turn a few heads. So far, that hasn't happened, nor is it confirmed by substantially higher rate volatility. But watch this space.



Source: State Street Global Markets, Bloomberg

Inflation Uncertainty

The University of Michigan survey records the standard deviation of 5-10y inflation estimates. The graph shows the 12-month moving average of that standard deviation is linked to term premium. For the purposes of the chart, the inflation series is truncated. The latest reading is 7.05, which is way off the chart. Meanwhile, term premium has remained low. At the minimum this is a risk factor for a higher term premium going forward.



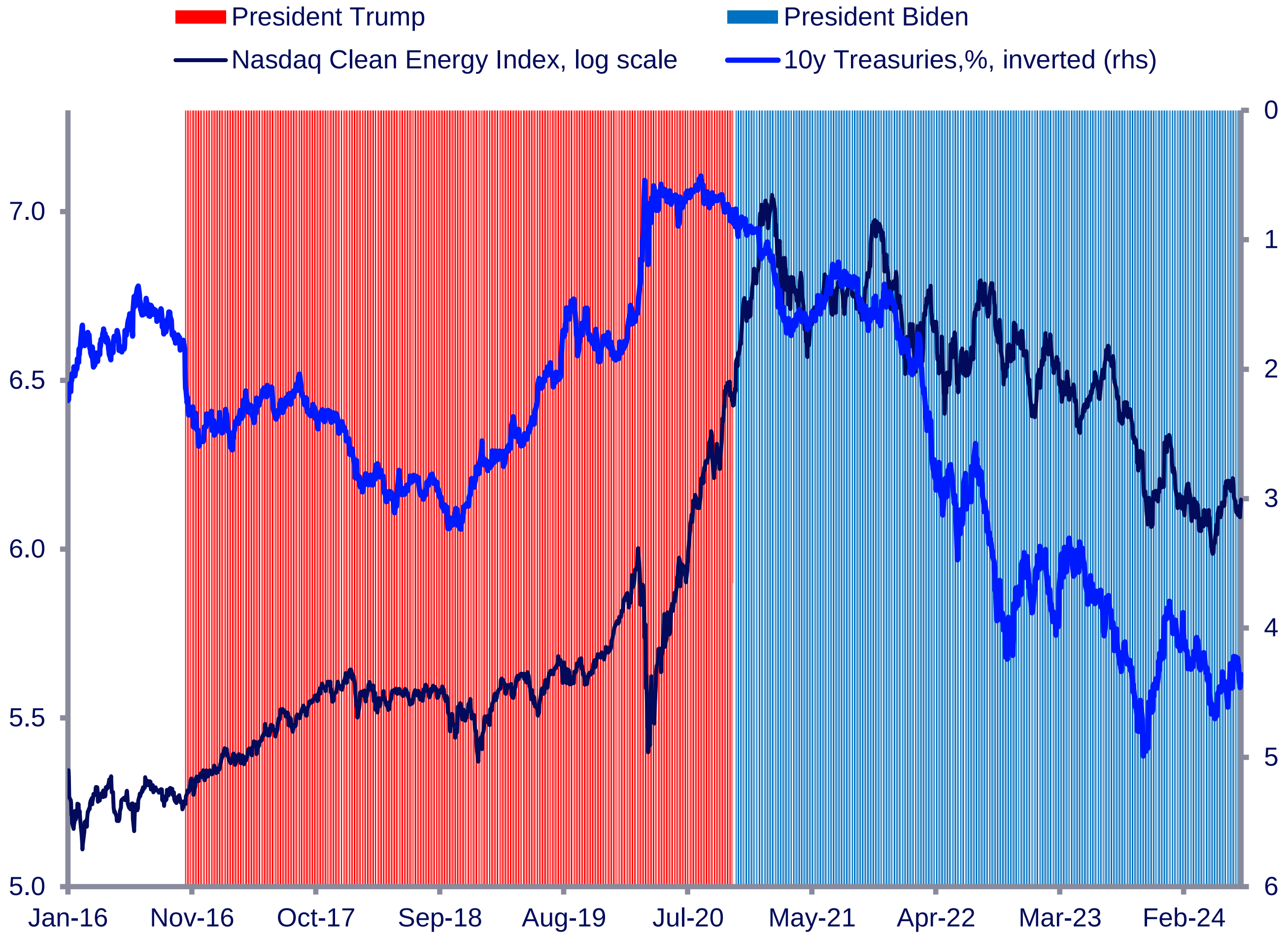
Source: State Street Global Markets, Bloomberg

STATE STREET

Green Energy and Presidents

Clean Energy stocks are seen as potential casualties should Trump get re-elected. We disagree!

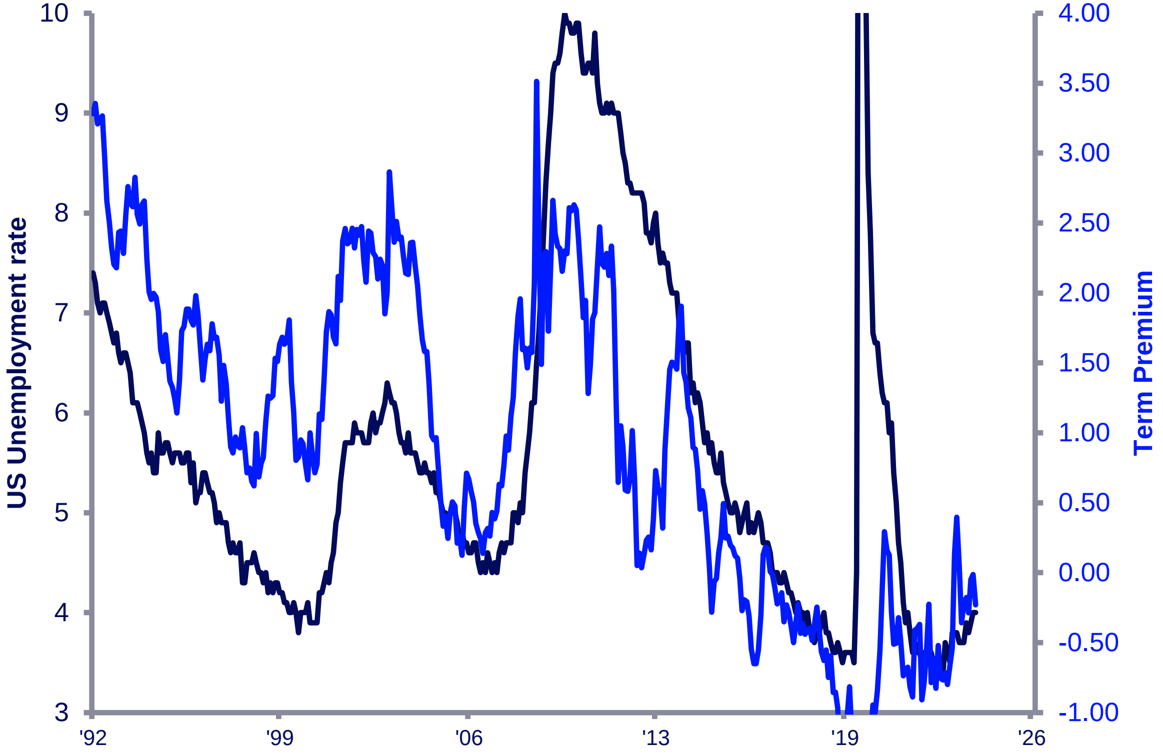
Green Energy stocks have fared far better during Trump's first presidency than Biden's, despite the latter's green credentials. Indeed, we find that interest rates are far better predicter performance of those (very capital intensive/interest rate sensitive) stocks.



Source: State Street Global Markets, Bloomberg

Is Term Premium linked to the Unemployment rate?

For the past 30-years US Treasury term premium as measured by the Adrian, Crump & Moench (ADMTP10) has moved in synch with the unemployment rate. There is a certain logic for this relationship. During periods of rising unemployment, economic uncertainty increases, which is reflected by a higher term premium. The last time the unemployment rate was above 4.0% was November 2021. If the U3 rate does surge above 4.0 and the Fed decides to begin a rate cutting cycle, this measure of term premium should increase. But would it necessarily mean a higher 10-year yield or just a steeper curve?



Source: State Street Global Markets, Bloomberg

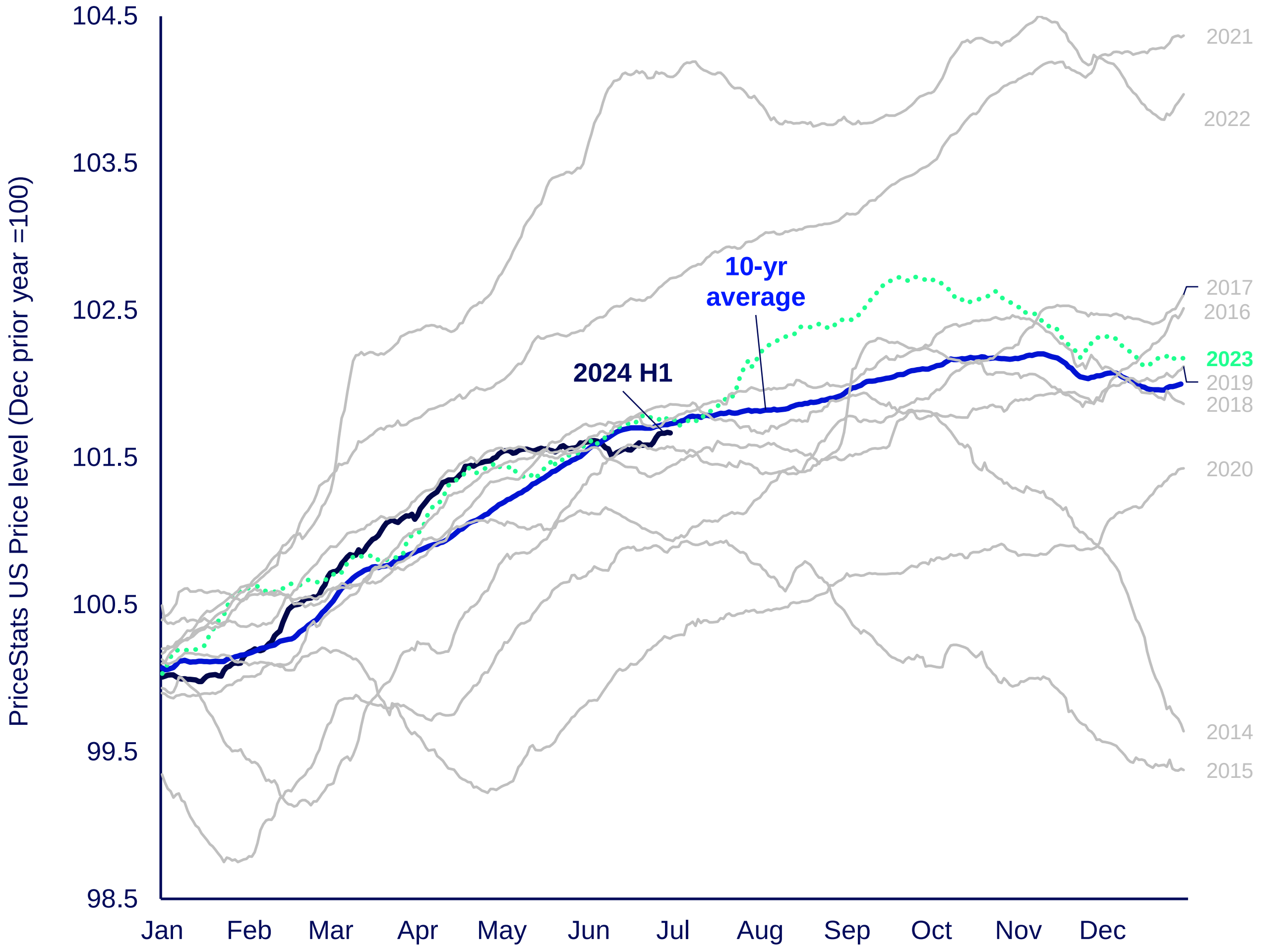
Inflation, an average year after all

Progress on inflation has been bumpy so far in 2024, but PriceStats points to a smoother ride over the summer.

PriceStats rose only 3bps in the month of June (nsa), the second consecutive month in which inflation momentum has been below seasonal averages.

This softer recent trend has been sufficient to bring the path of inflation back into line with the average trend seen over the past decade.

Assuming last August's energy shock is not repeated, such a benign run rate below seasonal norms will see the PriceStats annual inflation rate fall comfortably below 2% once again.



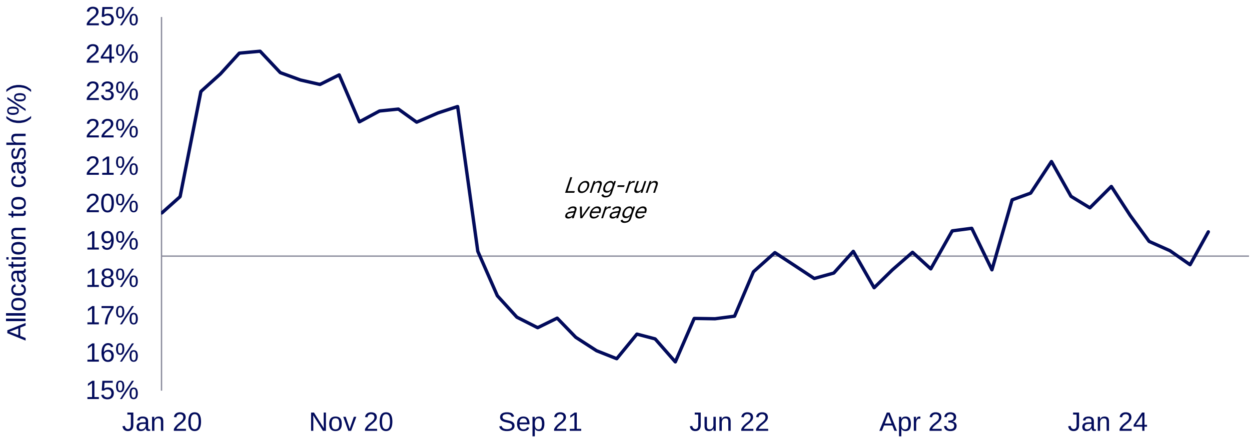
Source: State Street Global Markets, Bloomberg.

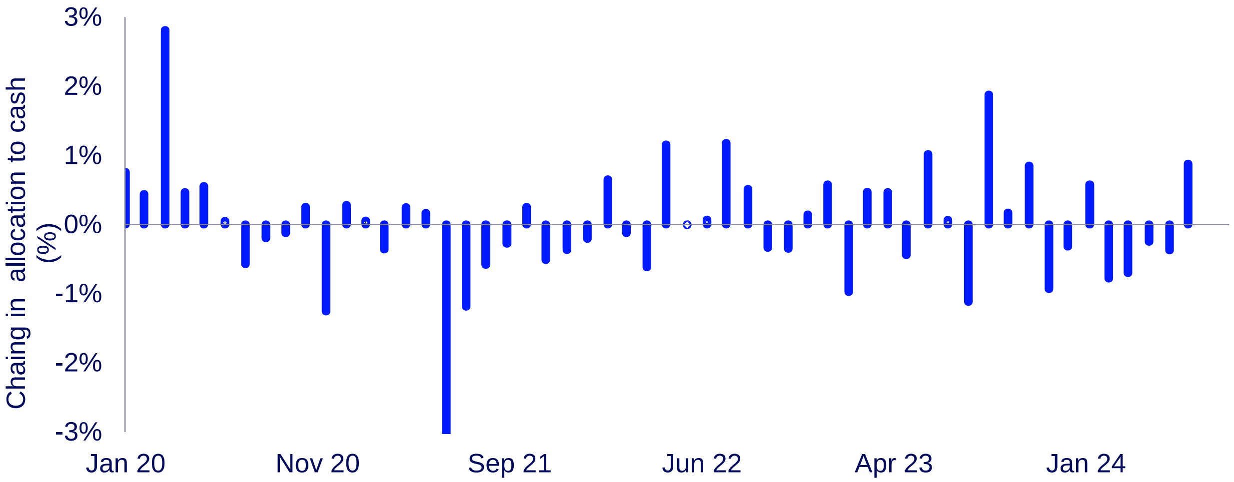
Investors shy away from cash underweight

State Street's institutional investor indicators showed that investors baulked at allowing their allocations to cash fall below their long-run average in June.

After reaching an eleven-month low at the end of May, cash holdings rose by almost 0.9% in June, the largest re-allocation to cash since the energy spike last August.

The move to cash came almost equally at the expense of equities and bonds and demonstrates that investors are becoming more wary of the investment environment in the face of evolving macro and political risks.



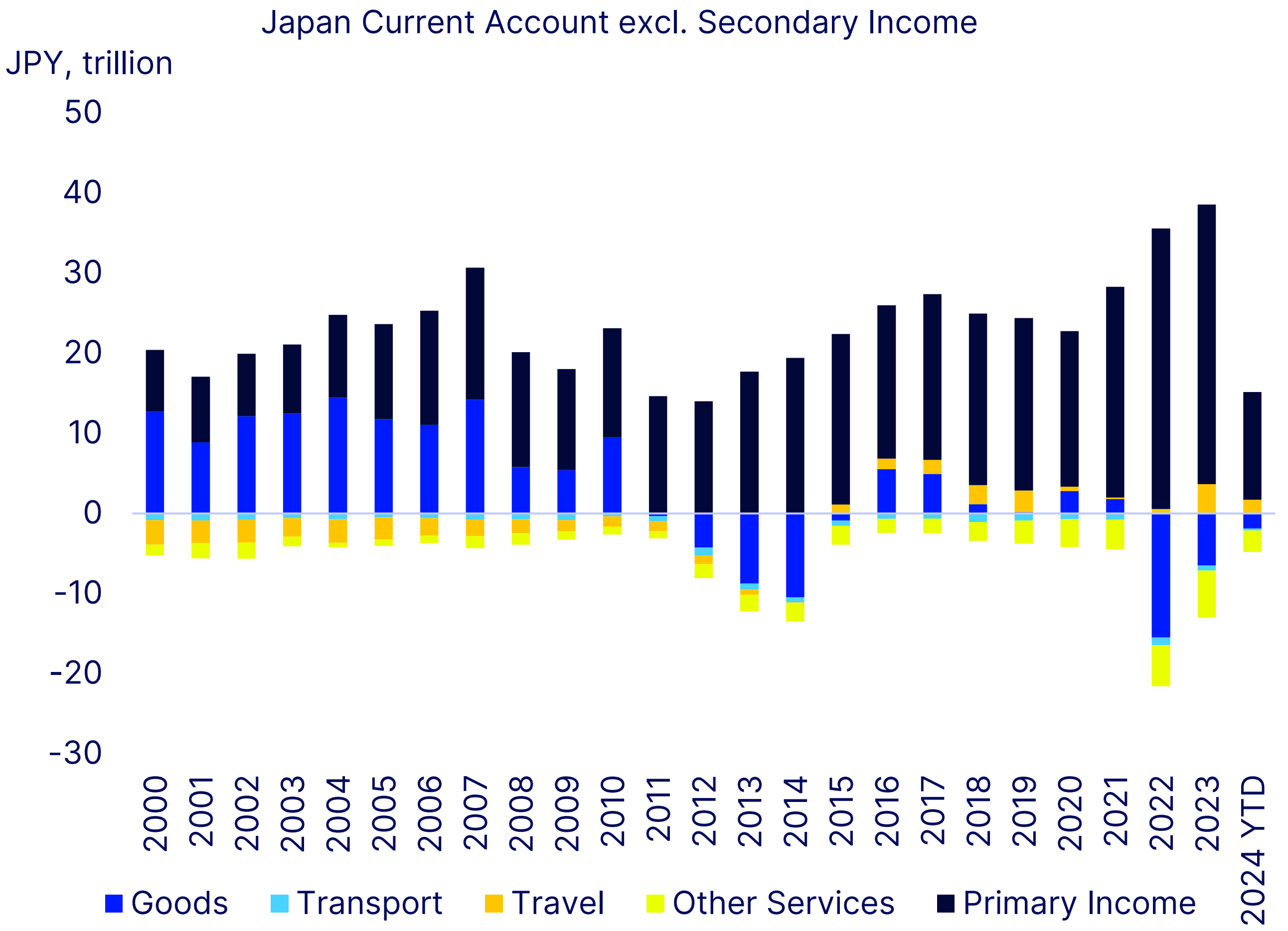


Source: State Street Global Markets,

Could a strong current account save the yen?

Japan's current account surplus rose to a record high in 2023. A large current account surplus is usually driven by trade, but things are different in Japan, where the surplus is mainly driven by the primary income balance from FDI and portfolio investments.

The high CA surplus creates an illusion of JPY strength, but the large yield differential between US and Japan suggests that Japanese investors may fear to convert foreign investments back to the yen, which creates a vicious cycle for the currency.



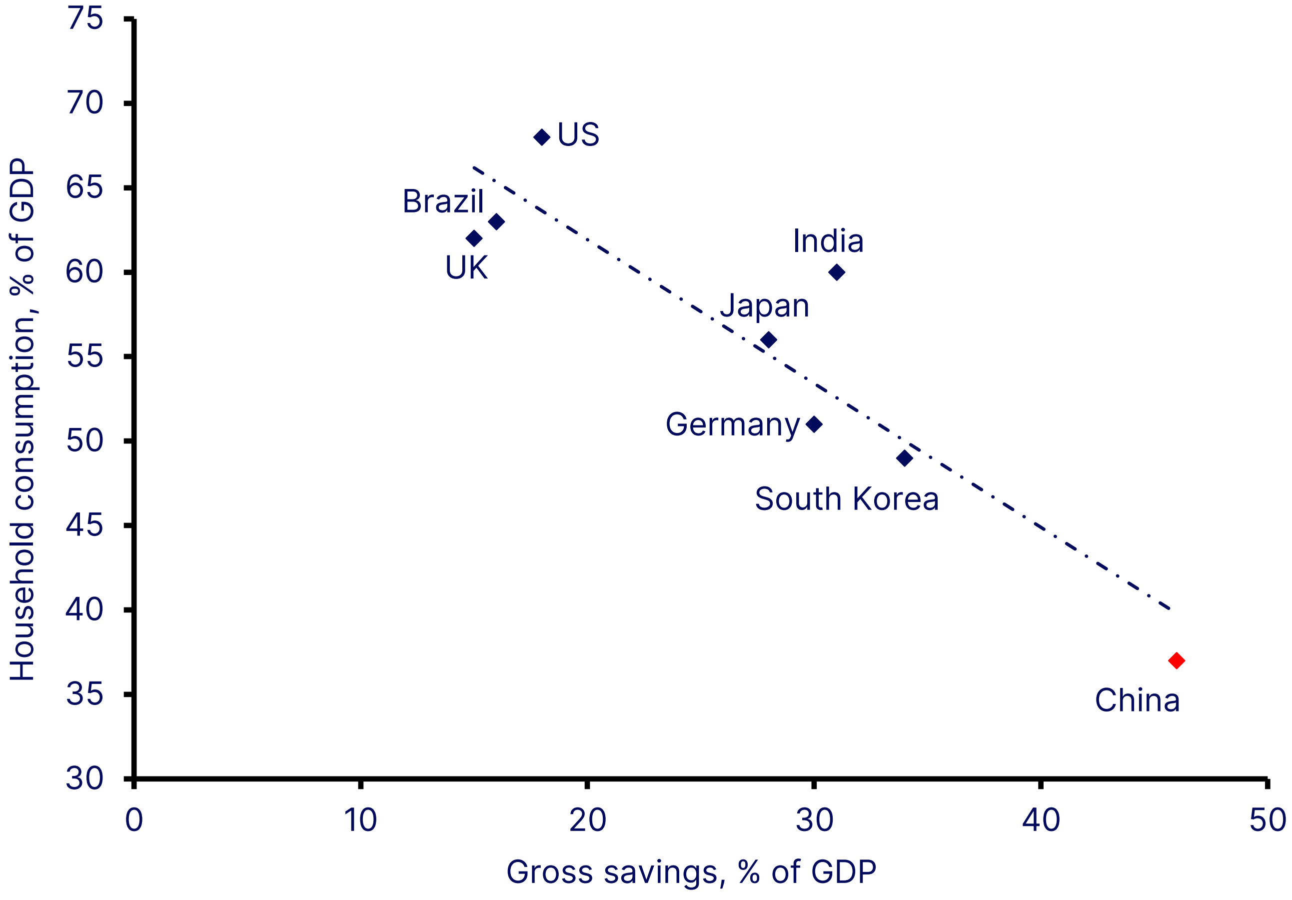
Source: State Street Global Markets, Ministry of Finance Japan.

The continuing search for China's consuming passion

Later this month, China's political, economic and military leadership gathers for the Third Plenum. Reform expectations are high following recent comments from President Xi on "a series of major measures" to support growth.

However, prospects for (supply-side) reforms might not put the Chinese economy on a sustainable growth path absent structural changes that spur consumer demand. This remains a missing piece of the growth puzzle: comparative analysis with developed and other major emerging markets note higher consumption and lower savings levels elsewhere. Efforts to stoke domestic demand conditions, first touted in the pre-Xi administration over a decade ago, remain an essential work in progress.

Consumption vs savings, 2023



Source: State Street Global Markets, World Bank.

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