Its not Inflation….but 'Deep' Deflation

During the recent MPC conference Fed governor mentioned – the full consequences of all our tightenings have yet to be felt'. Due to policy lag we cannot fully experience the consequences of tightening that has happened over the last year. Even without the full effects of those tightenings felt, inflation is decelerating and coming down. Slowing inflation creates less momentum for future inflation and with after effects of tightening yet to be felt, deflation and not inflation could be the concerns some quarters down the line. This is how dynamic systems work. A dynamic system is a system that feeds into itself, where the previous condition of the system impacts the future condition of the system and inflation is like that.

Back in 2020/2021 when real interest rates dipped very low, people borrowed like crazy which took long time to work through the session; but it created inflation. But, this inflation managed to self-arrest before the Fed even started to seriously come into the picture and stabilize. The original conditions for spike had to do with the supply chains and raising rates doesn't help to solve supply chain crises. But now, what we're seeing is falling inflation amid tightening policy and as money supply shrinks causes prices to fall in an environment where it's not warranted.

Rapidly falling inflation is positive for real rates, especially forward-looking real rates on instruments like TIPS which could be much higher than currently projected as inflation turns out to be much lower. For instance, real rates on TIPS have risen from minus 2% to positive 1% to 1.5%. We're on the path of overall inflation going down, and the Fed is keeping it down by raising rates and conducting tightening.

Interestingly, the economic data coming out is also mixed and not very straight forward. The stock market is currently being supported because the Treasury is drawing down ahead of the debt ceiling. So, liquidity has actually not been hurt too much by quantitative tightening, because it's like putting money from one pocket into another pocket. Sooner or later, they'll have to restore the reserves and money supply will start tightening again once the debt ceiling is passed. If you suck dollars out of the system, there will not be enough money to pay for things; which essentially adds on to the tightening process and thereby further reduces inflation.

Now, this is closely linked to the crude oil thesis as well. Energy supply at current prices is not adequate to facilitate global growth. So, if you're going to have global growth, you're going to have energy prices go up. Its is unlikely that in the near term there will be substantial increase in oil discoveries or the refining capacities. Similarly, it is unlikely that huge amount of fission reactors will be online in a short span or there will be very significant change in the green energy infrastructure. So, if global growth has to be sustained, energy prices have to go up.

(Alex Gurevich interview with Macro Voices)

However, oil trades in dollars and dollars are being sucked out of the system and with that there won't be enough dollars to pay for oil, the world won't be able to grow, hence the world will have to go into a global recession. For the global economy to return to pre-pandemic growth trajectory we need enough energy. It means we're not going to have the growth because there's not enough energy supply to enable that growth.

The current market forward for oil three years hence is between $65 and $70 i.,e backwardation from current levels. Any scenario for oil to be there at these levels 3 years hence needs to involve at least a recession and a deflationary recession, because an inflationary environment would also imply oil prices being much higher. For this trade to make money with oil ending up at $50-60 a barrel three years from now; needs Fed to persist in being tight and we will have a deflationary depression somehow caused by keeping rates really high and sticking there.

So, is this a time when you want to buy bonds because, hey, the top of the hiking cycle has to be the time to buy bonds?

Having an inverted yield curve is a good time to buy bonds. Paradoxically the more inverted the yield curve is, the better the time to buy bonds. Whenever there is any kind of persistent prediction of easing, much more easing than predicted occurs. It's a good trade to be long any portion of the curve.

The Fed will taper off their tightening whenever they do in a few months, they'll start easing, they'll go to zero by the end of 2024, and stay there for a few years. Presently, five years is about the right horizon to buy and hold. Maybe the structural inflation will overwhelm the cyclical forces and inflation will come back, leading to hiking again. In five years, there is little risk once they roll off.

Whats the *impact of tightening on the economy* and how long will it take to be felt?

The playbook is that the Fed raises rates and the first domino to fall is asset prices (check). The second domino is that economic activity slows down (kind of check the economic data is mixed, it's slowing down but not yet showing a broad catastrophe). The third domino is supposed to follow is unemployment, and the fourth domino is inflation. This is how the playbook goes. Now what we're seeing is that the domino of employment is just refusing to fall. Meanwhile, inflation is heading down pretty rapidly. We're not seeing that kind of consumer pain that would eventually lead to a sharp recession and unemployment.

(Alex Gurevich interview with Macro Voices)

So, in this cycle, the first domino to fall will be inflation. And then instead of crashing unemployment, what they will do is crush inflation and create a deflationary shock, which will eventually, as real rates go up and real wages go up, cause people to change their behavior, both in terms of hiring, taking out loans, and reducing the size of the balance sheet. This could eventually cause economic pain and employment.

By the time Fed realizes that we're heading towards a deflationary catastrophe, it will be too late, and there will be no way to stop it. Because when inflation is very negative, you're in a liquidity trap, and it will start hurting economic activity like it did in Japan.

But will *Gold recent gains reverse* if deflationary recession arrives?

Gold could witness $3000 in this cycle. Gold is not operating on the current liquidity but anticipation of future liquidity. Gold is like an oracle, saying there is money on the horizon. It might be a year from now, but the will of money is coming because there will be no choice for the Fed but to start printing money again from year from now. The moment we see interest rate cuts start and the new conversation about QE starts we could see a big bull run in gold. Gold did really well during the tightening cycle from 2007 to 2014 and had some volatility and proceeded to make new highs. It might do well at the end of the tightening cycle. It might be a little shaken up if we're heading towards a sharp economic collapse, but we might not get that sharp asset collapse because there's no systematic over-leveraging and stress. It's more like a slow eradication of excess cash, which the Fed will have to counter. As the Fed starts countering, gold will be the thing to buy.

Market Outlook *- Asset prices are driven a lot by liquidity; and the liquidity situation is currently positive as the market perceives the Fed to be more dovish. There will be headwinds in the next few months as the background of rising real interest rates will probably put some pressure on earnings and growth.*

(Alex Gurevich interview with Macro Voices)

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