US Economy

Three puzzles of the financial markets' tug of war

How the mix of bullish and bearish sentiments is muddying the picture

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8 HOURS AGO by: **Dambisa Moyo**

There are at least three puzzles in the financial markets, each offering an opportunity for investment upside, but also creating a reason for traders to pause.

First, is there finally evidence that the global economy is exiting the risk of global deflation, or is the uptick in the Chinese producer price index (PPI) simply a rebound in commodity prices that could reverse?

More than any other inflation measure, China's PPI reflects the state of global inflation. It feeds through to global consumer prices because China is the biggest producer of low-cost tradeable goods.

But what explains the increase in China's PPI? It was negative for years and seen as the source of global deflation, but turned positive (https://www.ft.com/content/1ff85e96-f9ca-11e6-9516-2d969e0d3b65) in the middle of the summer of 2016.

The question is whether the rebound is due to transitory effects such as commodity price increases, or if it is proof that the global economy is back in balance, with global supply more closely matched to global aggregate demand.

The latter suggests that China has been able to close down a considerable amount of capacity and that reshoring production back to the west may have begun to raise local costs, particularly if an increase in the country's labour prices are a driver of PPI. It also indicates that, perhaps backed by greater private and public spending, China's capital expenditure is picking up. However, if the trend in PPI merely reflects transitory effects, softer global commodity prices are likely to feed into both Chinese and globalhese indices and push inflation downwards.

Second, what is the right level of US yields?

Market commentary tends to focus on nominal rates and whether and how far, say, the US 10-year yield will increase with Federal Reserve (https://www.ft.com/content/0a01b148-0a58-11e7-97d1-5e720a26771b) interest rate rises expected this year (assuming these are not fully priced in already), or whether bond yields will decline if growth prospects slow. However, real bond yields better reflect the markets' view of sustainable real growth.

Yet, there is a lack of clarity as to why real yields are depressed. Either the bond market is smarter than everyone else and (correctly) predicting slow growth, or real interest rates are being held down by three technical factors — other than that financial markets don't believe in the economic growth prospects. Specifically, buying through quantitative easing, institutions' asset liabilities management strategies and ageing demographics (which are placing a premium on the return of capital, not return on capital) are all capping real rates. The third factor is here to stay but the first two factors are coming to an end, which could put upward pressure on real rates.

However, while real rates remain so low, there is an arbitrage opportunity for those who believe the US economy will rebound, such as the government or private equity companies.

By borrowing at the low cost of capital (US real rates are at 50 basis points) they can garner higher future real returns above this cost of capital if the economy does grow in real terms, say, above 2 per cent.

Third, how should market participants think about the divergence between equity markets — which continue to outperform, reflecting a bullish stance — and economic and political data that point to significant uncertainty and more bearish sentiments?

While it is true that consumer and business sentiment data have turned positive, and market multiples are at all-time highs, with the US S&P 500 index trading at nearly 30 times price-to-earnings, the country's first-quarter gross domestic product is tracking anaemically at below 1 per cent. Meanwhile, market euphoria is, to a great extent, resting on a confluence of policy promises around US corporate tax cuts, a substantial fiscal stimulus aimed at infrastructure and a retrenchment in regulation. Such optimism largely discounts the structural factors that inform a bearish view of the global economy, from technology and a concomitant jobless underclass, population pressures, widening income inequality, a mounting debt burden and relatively low productivity.

The next three months will be crucial in achieving some denouement to these quandaries. In particular, a key question will be resolved: is there actually fundamental economic growth underpinning the US economy, or is what the equity markets see as a pick-up in economic activity really just positive sentiment that could peter out? In effect, either we will see a convergence between sentiment and survey data and real economic activity data — or we won't.

There is likely to be more visibility around the path of US public policy, and oil price tensions between Opec-driven supply shut-ins (whereby oil is available but unused) and inventory build-ups will probably be resolved. But until then the winners in the tug of war between bearish structural factors and the bullish animal spirits that could drive more investment and support stronger growth remain a market mystery.

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