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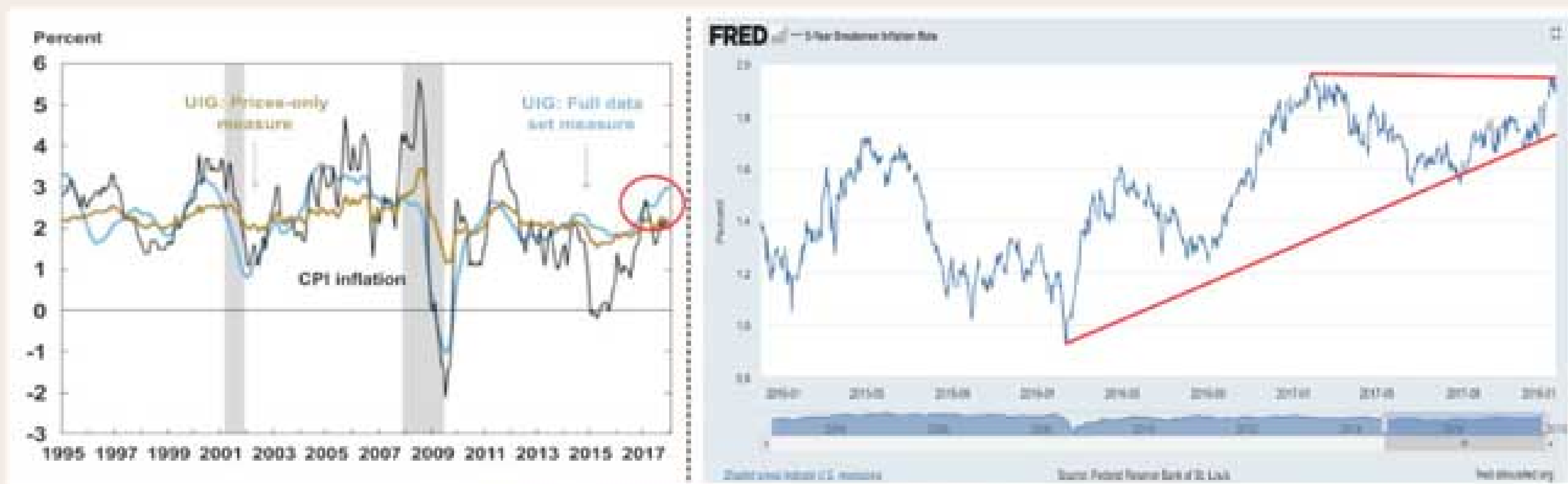
# WHAT I LEARNED THIS WEEK

Excerpt from January 18, 2018

## 3 Is global inflationary momentum building? Are you ready (continued)? Will "America First" provide an economic boost for emerging markets?

Both the New York Fed's Underlying Inflation Gauge (UIG) and the five-year UST/TIPS breakeven rate are signaling that the inflation bounce since last autumn's hurricanes is anything but transitory. The UIG increased from 2.96% in November to 2.98% in December—signaling trend CPI inflation of 2.2% to 3.0%—while the 5-year breakeven rate is close to breaking-out above its horizontal resistance level of 1.96%, as shown in the following charts. An acceleration of global growth could make the weakening dollar self-reinforcing, because of the greenback's position as an international funding tool. **And, if the dollar weakens further, it could propel inflation metrics higher, surprising market participants,** while simultaneously creating an economic drag that squeezes consumers. On top of all this, Washington's threats to pull out of NAFTA could undermine the dollar even further, providing even more fuel for inflation to rise.

**Underlying Inflation Gauge (left) and five-year breakeven rate (right)**




*Source: New York Fed (left) and St. Louis Fed (right)*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**A weakening dollar could feed on itself as dollar-denominated, emerging market (EM) credit expands**—the opposite of what occurred in 2015, when EM credit contracted, setting off a global cycle of deflation. As we have often argued, a weak dollar is good for emerging markets because it eases financial conditions on countries that borrow in dollars and enables them to invest and consume more—especially the EMs that export commodities which are priced in USD terms. This also applies to the euro to some extent, because the E.U. is a major exporter to EMs.

**If emerging market economies are strengthening on the heels of a weaker dollar, then they will have a greater propensity to buy more imports from the eurozone, offsetting some of the drag from a stronger euro.**

An October 2017 white paper by the Bank for International Settlements (BIS), entitled "The dollar exchange rate as a global risk factor: evidence from investment," examined the "triangular" relationship among the dollar, cross-border bank flows and real investment, and found that **the financial channel often outweighs the trade channel as it relates to dollar appreciation or depreciation**. This so-called financial channel of exchange rate fluctuations applies to borrower balance sheets and lender risk-taking capacity.

It concluded: "First, there is a strong negative relationship between the US dollar and cross-border bank lending denominated in US dollars. Second, **increases in US dollar denominated cross-border bank credit to a given EME are associated with greater real investment in that EME**. Finally, a decline in the value of a country's currency against the US dollar triggers a decline in real investment in that country…a stronger dollar has real macroeconomic effects that go in the opposite direction to the standard trade channel. **Whereas a stronger dollar tends to boost net exports [for the EME], the dampening effect of the [stronger] dollar on investment may temper any benefits that accrue from the trade channel**."

While it is no secret that Trump wants a weak dollar, it is ironic that **certain elements of his "America First" strategy—ostensibly designed to help American businesses—may result in an economic boost for emerging markets.** Bank deregulation is a good example. Hans Redeker of Morgan


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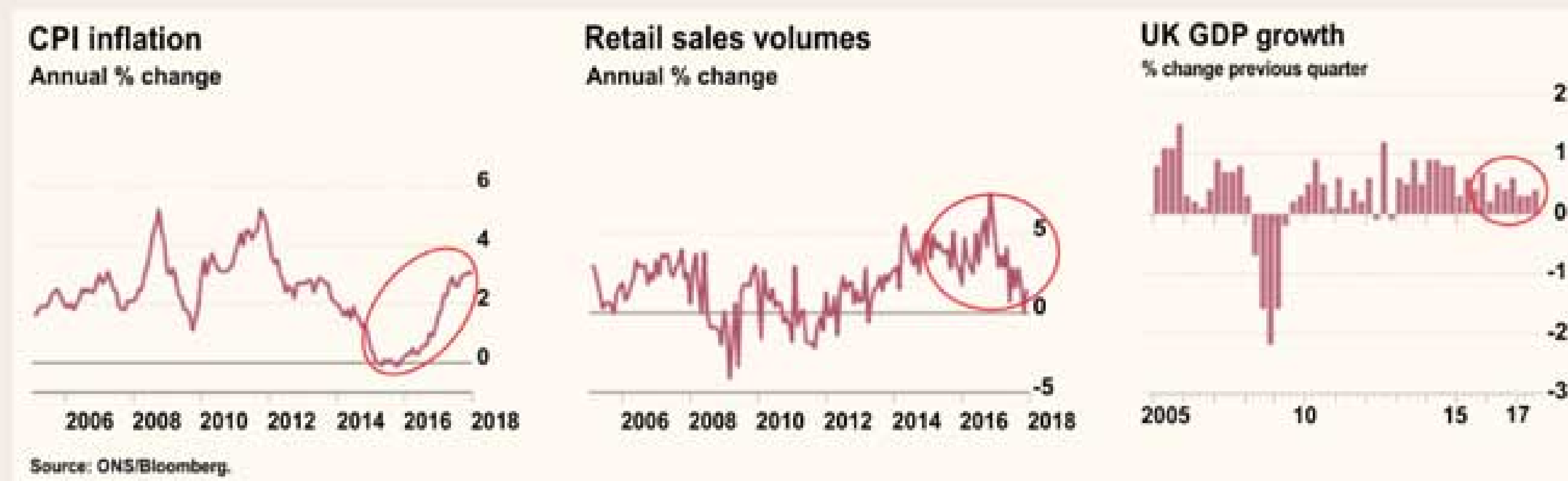
Stanley has argued that **freeing-up capital in the U.S. banking sector will, among other things, cause more dollars to flow into emerging markets in search of higher yielding assets, which should increase the supply of dollars on global markets.** For example, the average yield on the iShares JPMorgan USD Emerging Market Bond ETF is 4.9%, which is almost double the yield on ten-year U.S. Treasuries.

Moreover, **Washington's threats to pull out of NAFTA may also undermine the dollar by making it less attractive as a reserve currency**. At the very least, any move toward greater trade protectionism will result in higher prices for U.S. consumers. But, whether or not such a move will translate into meaningfully-higher wage growth remains to be seen. The squeeze on U.S. consumers worsened during the second half of 2017, as average hourly wage growth between June and December remained flat at 2.5% while the CPI accelerated from 1.65% to 2.12%.

**The U.K. provides a textbook example of how a weaker currency (relative to pre-Brexit levels) can undermine economic health, despite stimulating manufacturing activity.** The U.K.'s November 2017 CPI rose 3.1% year-over-year, which exceeded real year-over-year GDP growth of 2.3% in Q3 (0.4% q/q) and retail sales growth of 1.6% (December's CPI was up 3% as well). The trend in retail sales and GDP growth are both in the opposite direction of inflation, as shown in the following charts. Ironically, the manufacturing PMI fluctuated in a healthy range throughout 2017—between 54 and 58—despite falling into the contraction zone after the 2016 Brexit vote. Unfortunately, manufacturing only contributes 10% of the U.K.'s GDP today, down from 36% in 1948.




*Source: Bloomberg via Financial Times*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These trends underscore the risk of the Fed's falling behind the curve. **If U.S. inflation were to accelerate towards 3%—which is highly plausible if the dollar weakens substantially—and bond yields follow suit, the squeeze on consumers will worsen markedly**, especially considering that they have largely financed their spending spree by taking on more debt and saving less of their income.

Total consumer credit stood at an all-time high of 28.2% of personal consumption expenditures in 3Q2017—almost 2 percentage points above the pre-GFC high—while the personal saving rate of 2.9% is at a decade low, as shown in the chart below. The growing gap between the red and blue lines is not a healthy condition if interest rates are going to move substantially higher. As we have often argued: **"There's no such thing as a little bit of inflation, just like there is no such thing as being a little bit pregnant."**

### Ratio of consumer credit-to-personal consumption (blue, lhs) vs. Personal saving rate (red, rhs)

*Source: St. Louis Fed*


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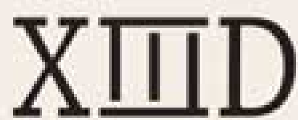


**GLOBAL 13D STAFF**
**WWW.13D.COM**
**13D-RESEARCH@13D.COM**

13D Global Strategy & Research,
6115, Estate Smith Bay, Box 2/Suite 333,
St. Thomas, USVI 00802-1304.
Telephone: (340) 775-3330 X-304.

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