Stagflation, sort of

China's slowdown, Evergrande contagion worries, supply chain disruptions, energy price surges, an appreciating dollar, rising Treasury yields, US debt ceiling anxiety, lingering Covid issues, North Korea firing missiles - this doesn't really feel like an optimal backdrop as we head into the fourth quarter...

Source: Shutterstock

Arise pessimists!

Those of you who know me well will know that I am not a glass-is-half-full type of person. I prefer to think of myself as a "dirty glass is cracked, filled with warm effluent and with a dead spider floating in it".

This psychological profile has been a great benefit during a life in financial markets, though I do have to regularly check my self-selecting indicators of impending doom against the rose-tinted worldview of the rest of the market - in particular, equity investors.

But this morning, it feels as if I have a few more members joining me in "Team-spider". US equities have not been having a bad time recently, but have certainly been struggling to go higher. Overnight, there was a substantial drop, with the S&P500 down around 2%, and the Nasdaq down closer to 3%.

Asian equity futures are, not surprisingly, looking a deep shade of red this morning, and it is hard to see what is going to turn that around in trading today. That said, this does feel like the equity market catching up on reality with other markets, FX and bonds, rather than anything substantially new to insert into our understanding of what is going on.

For example, EURUSD did decline a little further, but not much. It sits at about 1.1685 at the time of writing. It was just below 1.17 this time yesterday. That's an insignificant move. We've seen more movement in Asian FX, though not in China's currency, which should provide an anchor for much of the rest. We are seeing some further considerable weakness in some of the region's current account miscreants - THB, PHP (though not so much the IDR). But the weakest currency in our region over the last 24 hours was the JPY, which you would have expected to rally if this was all a big risk-off move with equities at the centre. Instead, this smells more like a rate differential move, with equities at the periphery adjusting to catch up.

Further fuelling that rate differential idea are the latest comments from St Loius Fed President, James Bullard. He told Reuters yesterday that he could see a case for two rate hikes next year. We've had further comments from Powell overnight attesting to more inflation being non-transitory, and 10Y US Treasury yields have gained further ground, pushing up to 1.537%, though the 2Y UST yield increase has slowed a bit now yields have reached 0.3%, and only added a further 0.5bp overnight.

Dataflow from the US last night was a mixture of positive inflation news and soft activity indicators. On the inflation front, the S&P Case Shiller house price inflation measure reached within spitting-distance of 20%YoY. If that doesn't alarm you, you have ice in your veins. On the growth side, we got more falls from the Conference Board consumer confidence indicator and a soft Richmond Fed manufacturing index too.

Stagflation mentions rising

While I can think of a lot of reasons why the term is inappropriate, the rest of the world seems to be getting more concerned about the idea of "stagflation". I quickly reminded myself how to do a trend search on Google this morning, and once I had convinced the engine that I didn't live in Vietnam, it spat out a chart that shows stagflation mentions moving up sharply in September.

However, it is hard to fully sign up to the stagflation argument when the split between temporary price-level adjustment and entrenched higher price and wage-setting behaviour remains unclear. And the "stag" bit of the term is relative. Absolute growth levels are actually very good (all things considered). But they are just down a bit from the height of expectations. Nonetheless, there are bits of what is going on that do fit the stagflation bill, so we might do well to at least consider this in the Stagflation-lite camp?

I mentioned in the summary at the beginning the litany of stuff that could be making you nervous about holding risk-on investment positions right now. They include the China growth slowdown, Evergrande contagion fears, supply chain concerns, energy price surges, food price spikes, an appreciating dollar, rising Treasury yields, US debt ceiling anxiety, lingering Covid issues, and North Korea firing missiles. There are certainly elements of this that you could slot into a stagflation hypothesis.

Optimists, quoting from 80s pop-band "D-ream", would have you believe (in contradiction to the second law of thermodynamics) that from this point, things can only get better. Team-spider would draw different conclusions. Where do you stand?

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