MV CAPITAL MANAGEMENT

Weekly Market Flash

The Reflation Pony Returns

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Gentle reader, please indulge us our seeming obsession with the subject of inflation. Yes, we know that other macro metrics matter as well, but inflation is both the big mystery – as we discussed in last week's column – and arguably the heavy hand pushing and pulling the market to and fro. Today we focus more on this "actionable" aspect of inflation. Or, to perhaps be more precise, we focus on the curious case of a market with the stars of an imagined reflationary surge sparkling in its eyes – in the very same week when yet another month's reading informs us that a pick-up in inflation is nowhere to be seen in the real world.

Not Dead Yet

It really doesn't take much, even after all this time. The so-called "reflation-infrastructure trade," which financial pundits necessarily rebranded as the "Trump trade," died an unofficial death back in the first couple months of the year. That's about the time when the US dollar swooned at the feet of a soaring euro and Aussie dollar, and value stocks in sectors like financials and energy ceded the high ground to their growth counterparts in tech.

But 2017 is, if nothing else, the year of endless lives, whether it be multiple attempts to repeal and replace healthcare policy or the renewed insistence that hypergrowth-fueled inflation is just around the corner. "The Trump Trade Is Back!" screamed Bloomberg News on Wednesday, joined by a chorus of like headlines from Yahoo! Finance, Business Insider and others. Once again financial institutions and resource companies were the market darlings. Bond yields perked up. Even the beleaguered dollar took a victory lap or two. Mr. Market was ready to party like it's late 2016.

A Framework of an Outline of a Plan

The catalyst for this week's effervescence, of course, was the release on Wednesday of a tax reform framework. It wasn't really a plan, because plans generally contain details about specific sources of revenues and costs over a defined time frame, grounded in plausible assumptions. The major assumption made by the authors of this framework is that it will somehow deliver anywhere from 3 to 6 percent (depending on whom in the administration you care to believe) in long-term sustainable growth.

Now, given that we have not experienced real GDP growth of that caliber for many decades, it would be reasonable to believe that a boost of that magnitude would beget more inflation, hence higher interest rates, hence the improved fortunes of banks and oil drillers and the like. Unfortunately for the credibility of the proposal's framers, the plausibility of sustained growth at those levels is vanishingly low. The Fed's median estimate of US long-term growth potential is 1.8 percent. Earlier this year the Congressional Budget Office estimated that if all the fiscal stimulus measures proposed at one time or another by the new administration (tax reform, infrastructure spend and all the rest) were successfully implemented, it could add one tenth of one percent to long term growth. So the Fed's 1.8 percent would become 1.9 percent, hardly reason to break out the Veuve Cliquot.

Back in the Real World

Meanwhile Friday morning delivered yet another Debbie Downer data point to the market's Pollyanna. The personal consumption expenditure (PCE) index, the Fed's preferred inflation measure, came in for the month of August below consensus expectations at 0.1 percent. That translates to a 1.3 percent year-on-year gain, matching its lowest level for the past five years and well below the Fed's elusive 2 percent target. We imagine this reality will likely show up again soon enough in the bond and currency markets (which also were the first to ditch the Trump trade back in February). But the stock market is a different animal. Is there enough wishful thinking to keep the reflation trade alive long enough to get through the tricky month of October and into the usually festive holiday trade mindset? Perhaps there is – money has to go somewhere, after all. At some point, though, reality bites back.

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