Interest rates and inflation will continue to rise

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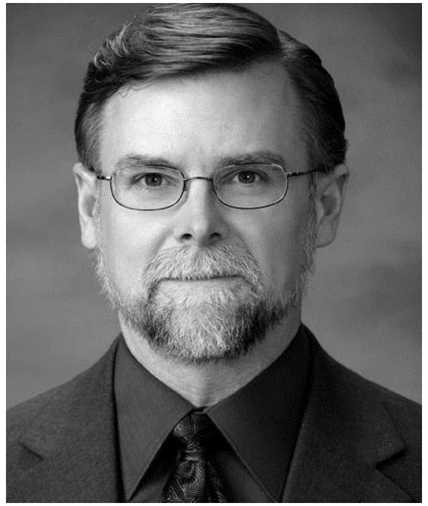

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Inflation

Today's context

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Markets

This Stock Strategist Says We'll See 5% Inflation for the Next Decade

- Fed's 2% target is a 'made-up number,' says Deluard at StoneX
- Economic growth has been faster with inflation in 4%-5% range

By Vildana Hajric and Michael P. Regan
December 3, 2022 at 2:00 PM MST

While the crypto horror show rages on, stocks have quietly rallied almost 10% in the last month amid cautious optimism that the worst of the inflation shock is over.

But might it be a head-fake? And what's in store for equities in 2023? Vincent Deluard, director of global macro strategy at StoneX Financial, joins this week's "What Goes Up" podcast to talk about why he's not convinced inflation will fall anytime soon.

Here are some highlights of the conversation, which have been condensed and lightly edited for clarity. Click below to listen to the full podcast, or subscribe on Apple Podcasts or wherever you listen.

5% Inflation for a Decade? (Podcast)

Q: You say the real Fed pivot won't be to cut rates in 2023, but to accept that a decade of 5% inflation is the least painful way to deleverage the economy, reduce inequalities and restore sustainable growth. How does that play out in markets? And what's driving that inflation?

What is the bond market forecasting

- Slightly over-simplifying . . . it is the difference in current yields between regular Treasuries and TIPS . . . of identical maturities

- 5 years 2.5%
- 10 years 2.4%
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What would it take for the numbers at the left to be correct?

1. The factors that caused inflation disappear
2. The Federal Reserve tightens and reduces monetary growth
3. The federal government meaningfully shrinks future spending

Important inflation qualifications

Drawn from today's . . . quite serious realities

Rob's attempt at . . . current-day qualifications

- It's all about COVID
- And the US government's response to COVID
- And many other country's . . . respective responses to COVID

- We seriously need to modify our history-based conclusions for the once-in-a-hundred-year event of COVID

- I <u>struggle</u> to see . . . how COVID has anything to do with "long-run" <u>interest rates</u>

- BUT . . . It has serious implications for inflation

How did inflation get to today's extreme high level

- Why did/is inflation happening . . .
  - COVID
    - Millions left the labor force . . . stopped working
    - The global supply chain broke . . . and it takes years (not months) to reconnect it
    - Consumers got bored . . . and just started buying stuff . . . a lot of stuff
  - **Federal government stimulus**
    - Monetary - by Federal Reserve
    - Fiscal - spending by the US Congress
  - **Every other government did the same thing**
  - Ukraine
  - Deglobalization

What happens to inflation next

- It goes down . . . BIG time

- Security markets are forecasting inflation to AVERAGE just
  - 2.5% over the next five years

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Why or how?

1. The things that caused inflation go away
2. Recession

Why is it necessary that inflation falls from today's level

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These six factors are all working in reverse, serving to push inflation back down

These two factors are working hard to drive inflation higher

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Why or how?

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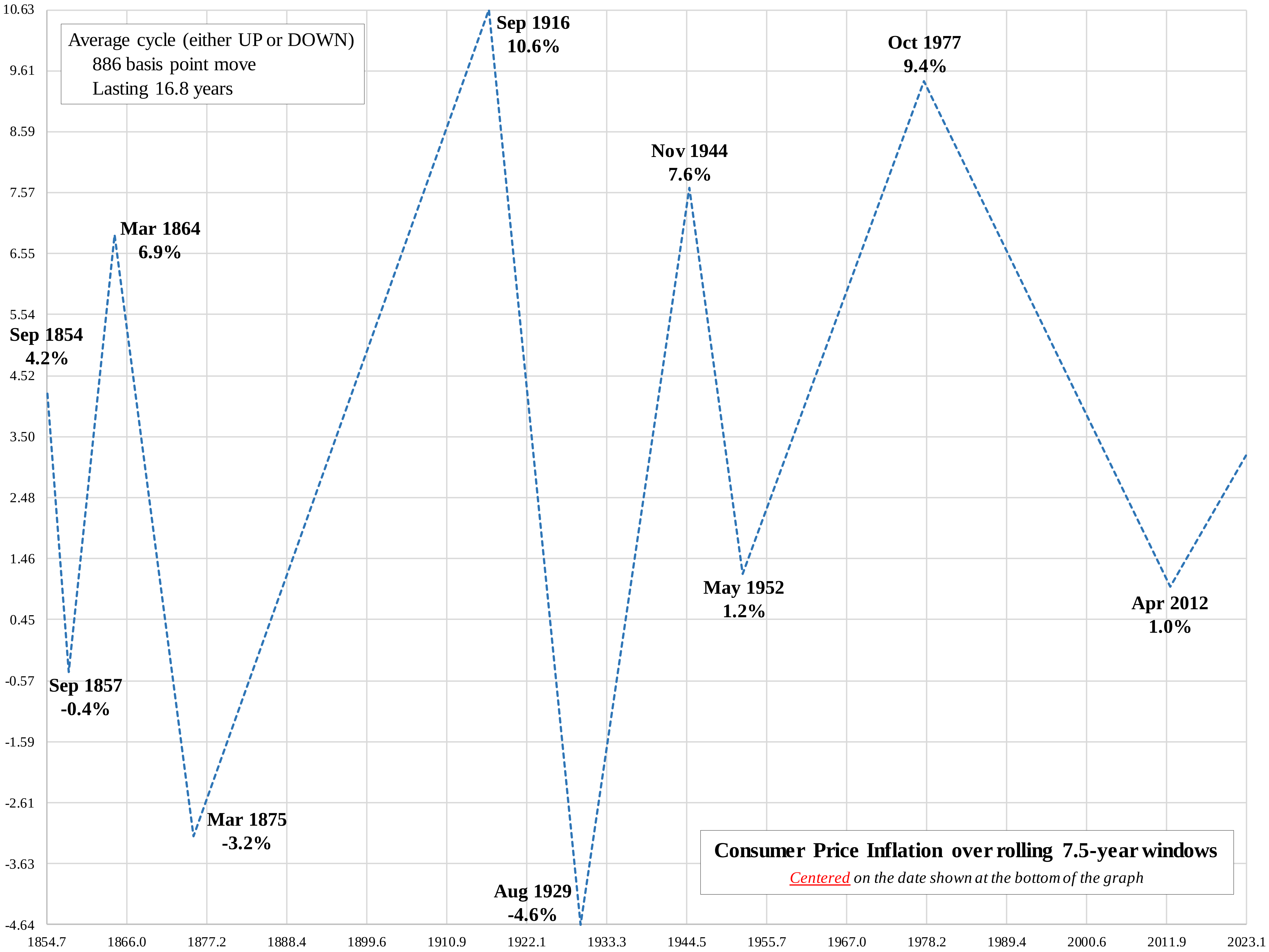
But then it goes back UP

Inflation and interest rates

Over the long-run

Since the 1800s



Average cycle (either UP or DOWN)
886 basis point move
Lasting 16.8 years
Consumer Price Inflation over rolling 7.5-year windows
Centered on the date shown at the bottom of the graph
Sep 1854 4.2%
Sep 1857 -0.4%
Mar 1864 6.9%
Mar 1875 -3.2%
Sep 1916 10.6%
Aug 1929 -4.6%
Nov 1944 7.6%
May 1952 1.2%
Oct 1977 9.4%
Apr 2012 1.0%
10.63
9.61
8.59
7.57
6.55
5.54
4.52
3.50
2.48
1.46
0.45
-0.57
-1.59
-2.61
-3.63
-4.64
1854.7
1866.0
1877.2
1888.4
1899.6
1910.9
1922.1
1933.3
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1978.2
1989.4
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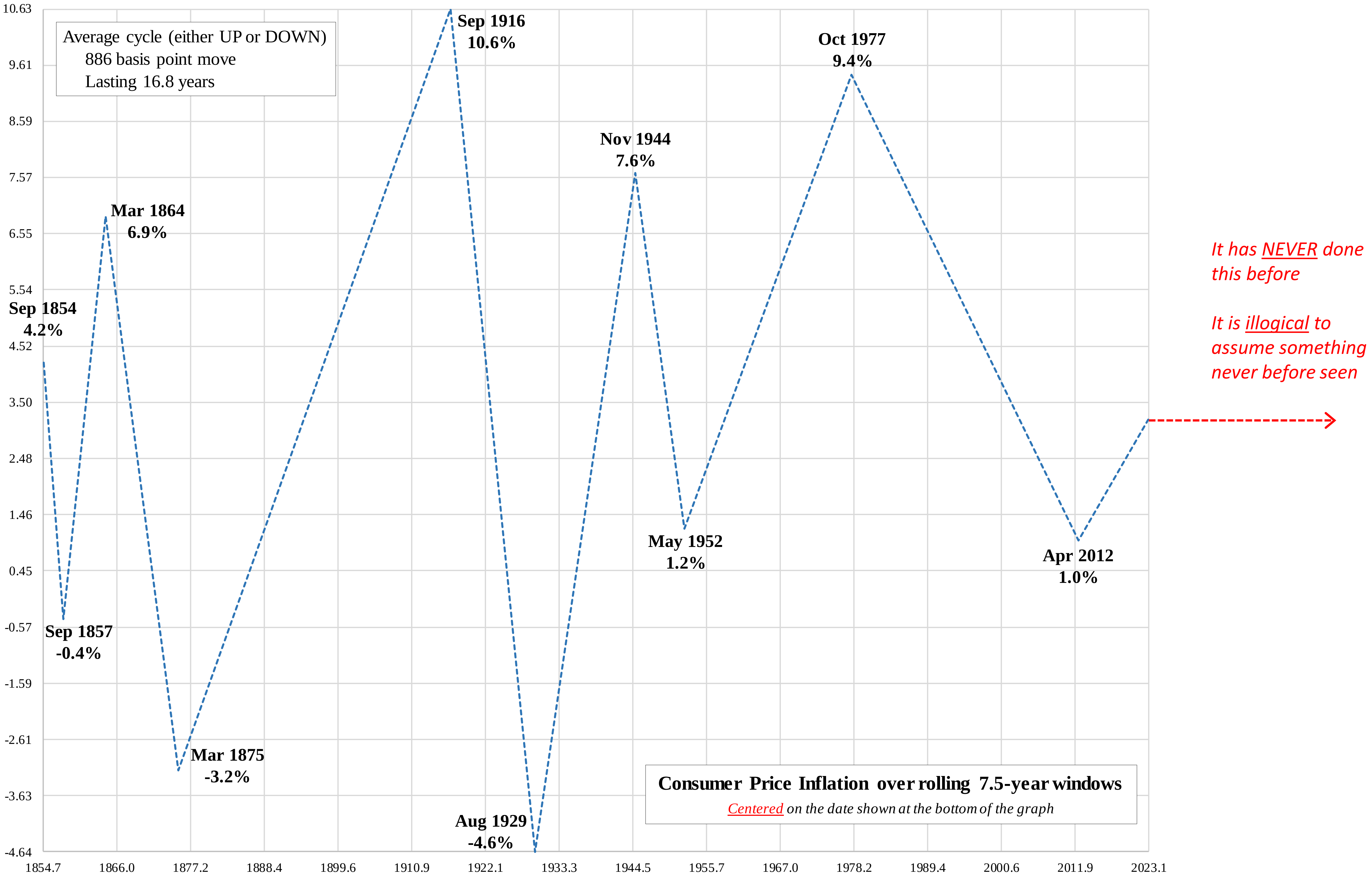
2023.1



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It has NEVER done this before
It is illogical to assume something never before seen
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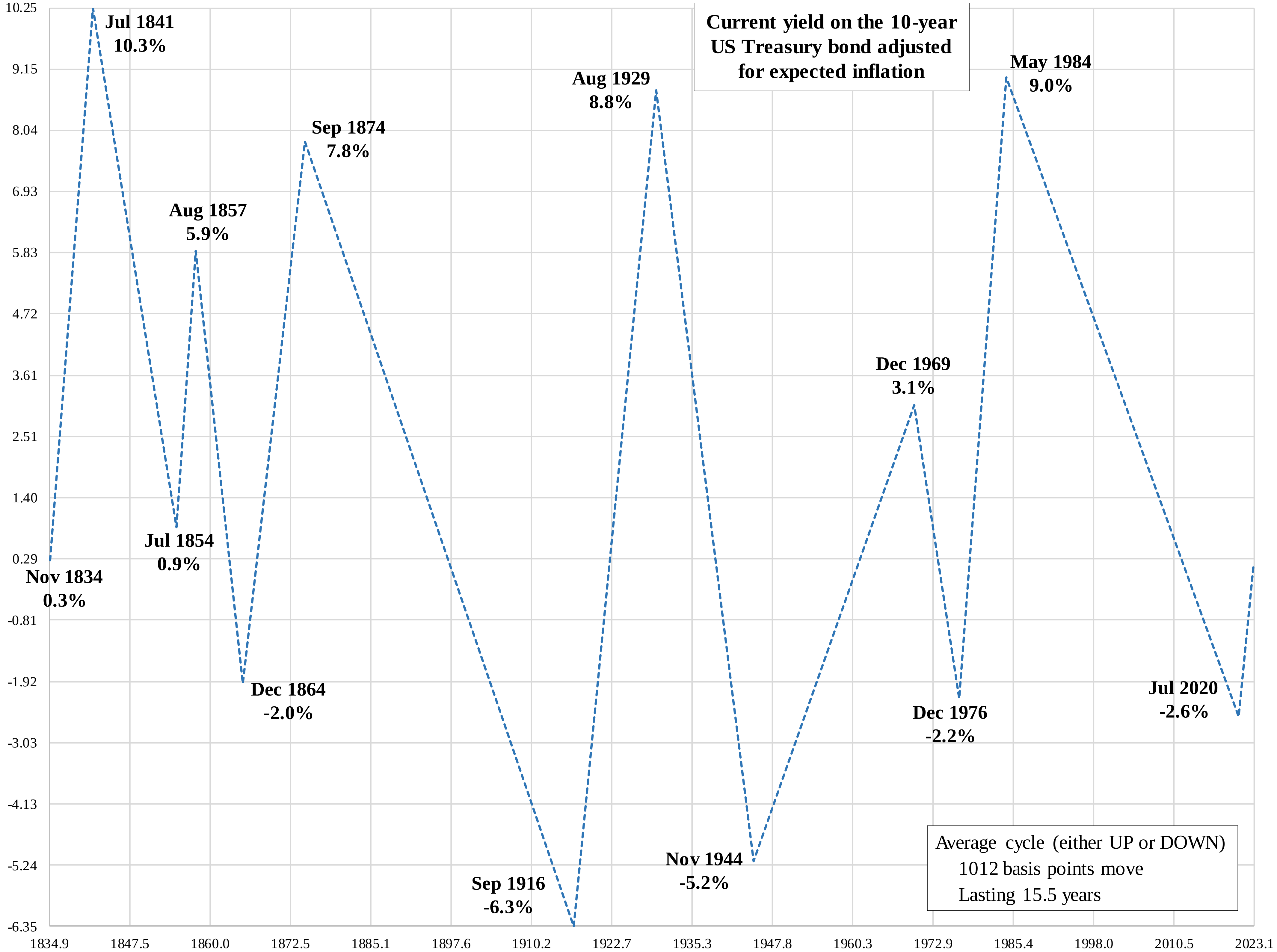
Current yield on the 10-year US Treasury bond adjusted for expected inflation
Jul 1841 10.3%
Aug 1857 5.9%
Sep 1874 7.8%
Aug 1929 8.8%
May 1984 9.0%
Dec 1969 3.1%
Nov 1834 0.3%
Jul 1854 0.9%
Dec 1864 -2.0%
Sep 1916 -6.3%
Nov 1944 -5.2%
Dec 1976 -2.2%
Jul 2020 -2.6%
Average cycle (either UP or DOWN)
1012 basis points move
Lasting 15.5 years
10.25
9.15
8.04
6.93
5.83
4.72
3.61
2.51
1.40
0.29
-0.81
-1.92
-3.03
-4.13
-5.24
-6.35
1834.9
1847.5
1860.0
1872.5
1885.1
1897.6
1910.2
1922.7
1935.3
1947.8
1960.3
1972.9
1985.4
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2010.5
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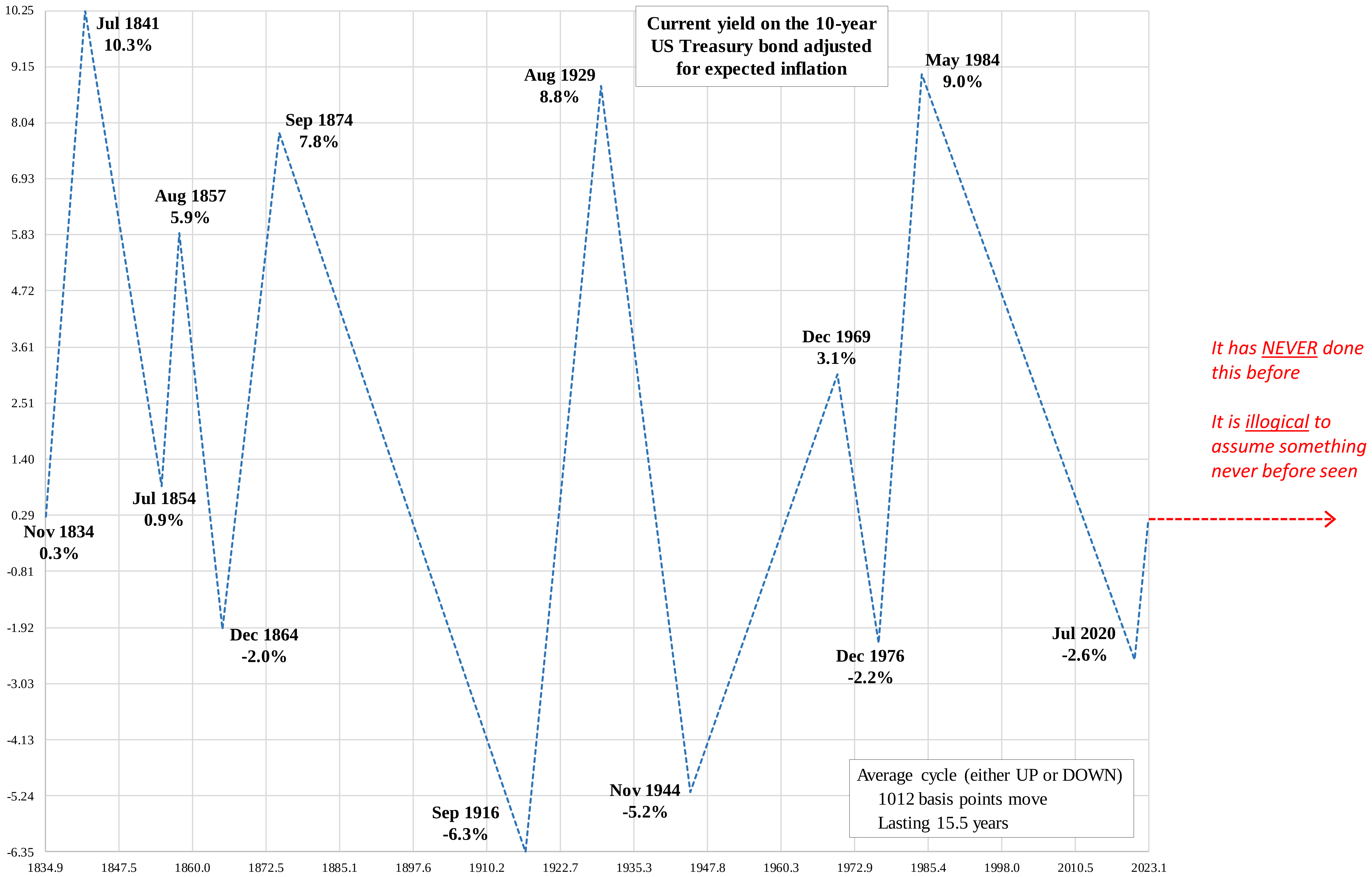

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1012 basis points move
Lasting 15.5 years

But why ?

It’s always necessary to ask and adequately answer the question of “why?”

Today the current yield is impossibly low

- Today interest rates are impossibly low

- 3.92% is the current yield on a 10-year Treasury
- If you live in NYC and are in the highest marginal tax bracket
- 1.97% is you after-tax return
- If inflation averages 4% over the next 10 years

- You will lose -2.03% every single year for 10 years

The BIG issue at play . . . What is really determining everything

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- It's all about funding (paying for) . . . projects . . . that're at play

- Society and governments have several projects that they're attempting to finance
  - Hot war with Russia
  - Cold war with China
  - Conversion from fossil fuels to renewables
  - Income inequality gap
  - Wealth inequality gap
  - Expanding social welfare programs
  - Transitioning from one political structure . . . to a different structure
  - Deglobalization

- Inflation is a method for both obscuring the cost . . . and dispersing its burden

Politics

- Just stop
- Just stop
- This has absolutely zero to do with which political party gains dominance
- The forces at play are far far larger than any political differences . . . which honestly are trivial

What’s to be done

- The old irrelevant approach is dead . . . For goodness sake, just admit it’s dead
  - MPT - Modern Portfolio Theory
  - Mean variance optimization
  - 60/40 portfolio
  - See the very nice piece on this by GMO . . . out of Boston

- What works . . . What’s needed
  - Tactical asset allocation (TAA)
  - Serious, institutional, well-structured . . . alternative investments . . . If it’s offered at a B/D it won’t work

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Best of both worlds - ESG and performance

Friday

March 17th

11:00 a.m. EASTERN

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